Ames Department Stores, Inc.

For the Fiscal Year Ended
January 30, 1999

Company Mission

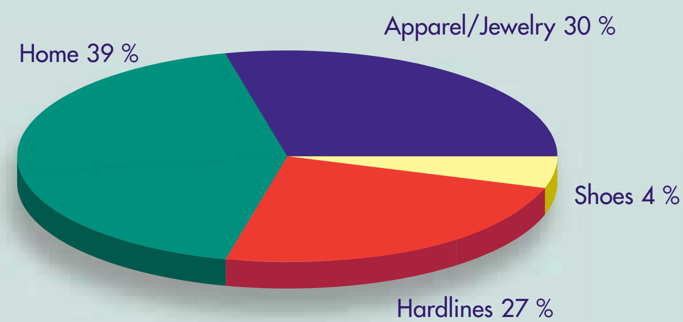
- Provide quality products for family and home at discount prices
- Provide a convenient and efficient shopping experience
- Achieve a sustainable competitive advantage
- Build and sustain strong supplier partnerships

Company Profile

Ames Department Stores, Inc., the nation's largest regional discount retailer, excels at satisfying a large, but underserved, block of consumers by providing them with quality, brand-name merchandise, low prices, friendly service, and shopping convenience.

As a full-line discount retailer, Ames provides customers with merchandise across a broad array of categories, including family apparel, housewares, domestics, electronics, ready-to-assemble and patio furniture, jewelry, crafts, pet supplies, health and beauty care items, stationery, sporting goods, toys, seasonal products and more.

Merchandise Sales Mix



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financial highlights

$ 2,507

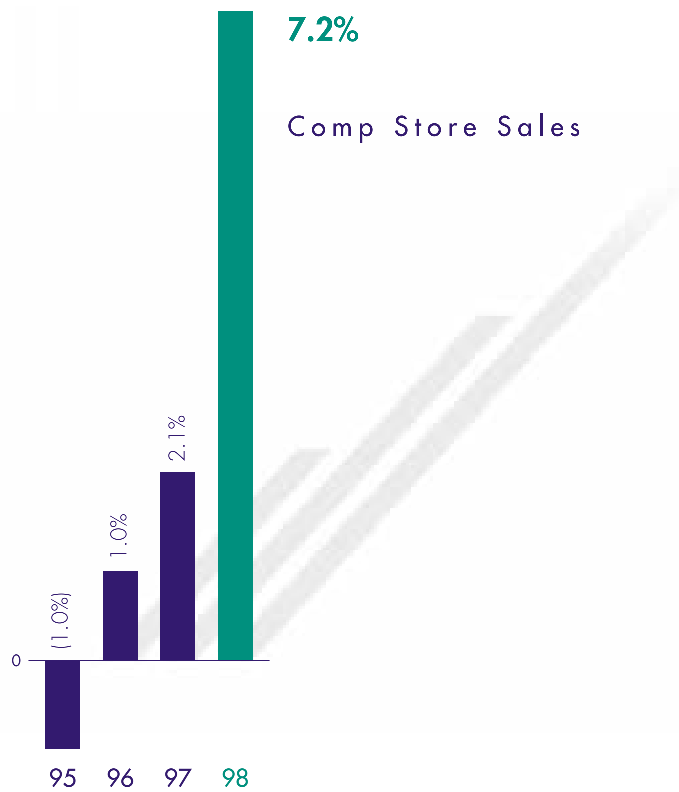
Net Sales Growth

(Dollars in millions)

$ 736

Market Capitalization
(at fiscal year-end)

(Dollars in millions)



7.2%

Comp Store Sales

A+ letter to

By every measure, 1998 was a year of record operating results and pivotal change for the Company. By year-end we had achieved a 39 percent increase in the earnings of our core business, the Ames stores prior to the Hills acquisition. At the same time, through the acquisition of Hills Stores Company, we increased the number of Ames stores by over 50 percent. We are very proud of these achievements and of our commitment to our shareholders and to our customers. We will continue to work to create shareholder value.

The highlight of the year was our acquisition of Hills Stores Company, a group of 155 stores in 12 states in the Northeast and Midwest regions — a company very much like our own in terms of the size of its stores, its customer base, its supplier-partners and the markets they serve. There was probably no other store group which complemented our store base more closely. This transaction dramatically and strategically expanded our geographic marketplace towards the South and Midwest as it extended our reach towards millions of value-driven customers very similar to those already fueling our success. With this acquisition, the total square footage of the Ames family of stores has increased by approximately 70 percent and we are now the largest regional discount department store chain in the United States.

We began this February to convert the Hills stores to the successful Ames format. We are not new at this. We have previously acquired and converted many stores to the Ames formula and have delivered on these investments with returns consistently above plan. The transition of the Hills stores will be staged in three groups. The first group held its very successful Grand Openings on April 22, 1999. The balance of the stores will open in July and September. All of the conversions are planned to be completed in time so they will be ready for the 1999 holiday sales period.

How have we achieved our success? We know who our customers are and we understand their needs. We offer them the products they want at competitive prices. We give them value and our performance demonstrates we are meeting their needs. We also provide them convenience; the size and layout of our stores make them easy to shop. We have invested in state-of-the-art systems to speed checkouts; we offer focused programs, such as 55 Gold®, to address specific target markets which we expect to grow exponentially as the population ages; and we offer A+ customer service. Not just a catchphrase, but the foundation of our business. We have created a solid identity, a template for success upon which we can build for the future.

s h a r e h o l d e r s

Another element of our success is our focus on building and sustaining strong partnerships with our vendors. These partnerships allow us to further enhance both sides of the price/value equation. As our operations grow in size and efficiencies we can leverage these strengths to the benefit of both our customers and our suppliers.

The most rewarding part of my job is the time I spend in the stores talking to customers and associates. The feedback I get is invaluable. Many of the innovative approaches we have put into place at Ames have come directly from listening to our customers and implementing their suggestions. We have made sure that the resources and the flexibility are in place to quickly and decisively respond to opportunities.

I would also like to extend our gratitude to Ms. Laurie Shahon for the many contributions she made to our company as a member of the Board. We wish her luck on her new endeavors.

Finally, we look forward to the challenges we may encounter as we continue to grow the Company, serving customers and supporting communities, while fulfilling our mission of creating value for our shareholders. We believe that the Company is at the beginning of an exceptional chapter in its history and all of us at Ames eagerly anticipate the opportunities that lie before us in 1999 and beyond. ■

Sincerely,

Joseph R. Ettore

President and Chief Executive Officer
May 12, 1999

A+ v i s

Ames' success is a product of both our strategic vision and our determination to stay focused on Ames' competitive advantages. This commitment, our "A+ Vision," has served us well over the last five years, driving net income from our core business to new highs. In 1998 our core business realized a 39 percent increase in earnings over the prior year.

Our strategy for achieving this competitive advantage has six key components.

1. Targeted Customer Base

People who shop at Ames make up a clearly defined market of consumers whose demands for value are not adequately met by other discount retailers. Although Ames is not the first retailer to go after this underserved market, we have been able to pinpoint the needs of each key segment and succeeded in meeting those demands on a broad scale. By carving out significant market segments of loyal customers — for example, working mothers, shoppers looking for larger sizes, and people age 55 and over — we have managed to profitably coexist, rather than compete, with larger national retailers.

2. Merchandise Mix

Our time-starved customers tend to buy closer to actual need than ever before. To satisfy them, the right item must be in stock at the right time. Ames' sharp focus on our target market extends to fine-tuning the merchandise selection of each Ames store based on the specific demographics and seasonal needs of that store's customers. Coordinating our new, computerized inventory control systems with those of our suppliers has greatly enhanced our ability to micro-market to the specific needs of each store location. The results are higher sales volumes and margins, fewer markdowns, negligible rain checks, and, overall, greater value for Ames customers and shareholders alike.

3. Price/Value Equation

Ames' Price/Value equation is at the heart of our success. We never lose sight of this first rule of customer service: Provide shoppers with quality products at fair prices. That is what our customers demand, and that is what we give them every day. Programs such as the Ames Advisory Board, through which customers tell us exactly what they want, enable us to identify a never-ending stream of opportunities for building store traffic and sales.

The growing size and success of our enterprise enables our suppliers to continue improving the value of the products and programs they offer.

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4. Promotional Marketing

Our value-driven customers respond to Ames' commitment to keep them informed about special values. A large portion of our sales is generated through our weekly circulars and other promotional and special event advertising such as Special Buy and 55 Gold®. Our suppliers often participate in these promotions, as well as in 55 Gold® and other event-related activities, helping us maintain our gross margins while attracting more and more customers to our stores.

5. Convenient and Friendly Store Layouts

Ames stores average 60,000 square feet of selling space, smaller than the mega-stores some of our competitors operate. We carry a merchandise selection of outstanding depth and breadth, while speeding and simplifying shopping for our customers. Wide aisles, soft corners and highly visible signing make shopping at Ames a breeze, while our merchandising systems keep all goods available to customers and sales associates alike.

6. A+ Customer Service

Every Ames sales associate is trained in our A+ Customer Service program. We all believe that our core strength lies in how we treat our customers: a smile, a greeting, meeting our customers' needs and thanking them. This opens the way to a consistently more pleasant shopping experience, as well as the one-on-one interactions that can lead to additional sales. Through our Service Award Program we recognize those associates whose service excellence earns them customer praise. ■

"We know who our customers are and we understand their needs. We offer them the products they want at competitive prices. We offer them value and our performance demonstrates we are meeting their needs."

— Joseph R. Ettore

A+ perf

Ames stock was a strong performer on the NASDAQ exchange in fiscal 1998, with a year-end over year-end share price increase of over 110 percent. Analysts broadened their coverage of Ames, another measure of growing investor interest in our Company. Ames' performance in 1998 reflects much more than our record-breaking financial results. We also fulfilled our commitment to perform for the communities which make and keep us strong. Ames has a special commitment to children, especially those afflicted with disabling and life-threatening illnesses. In the past year, company-wide fundraising events and corporate donations supported organizations dedicated to improving the lives of these children. Since October 1997, through a variety of in-store promotions, Ames has raised funds for the Muscular Dystrophy Association, the March of Dimes, and the Cystic Fibrosis Foundation.

Ames is also committed to making the holidays brighter for ill and underprivileged children. Last year, Ames associates donated over 1,000

Fiscal 1998 set several records — beating not only our previous achievements, but also our own expectations for increasing total shareholder value. In 1998 sales rose to $2.507 billion (including one month of Hills results); our core business earnings per share grew by 39 percent, and comparable store sales were up 7.2 percent.

Gross margins for the full year held at 28.2 percent and our overhead costs dropped by 80 basis points to 25.3 percent. These measures reflect the continued focus on expense control and the efficiencies which have been effected through our state-of-the-art systems and excellent vendor-partner relations.

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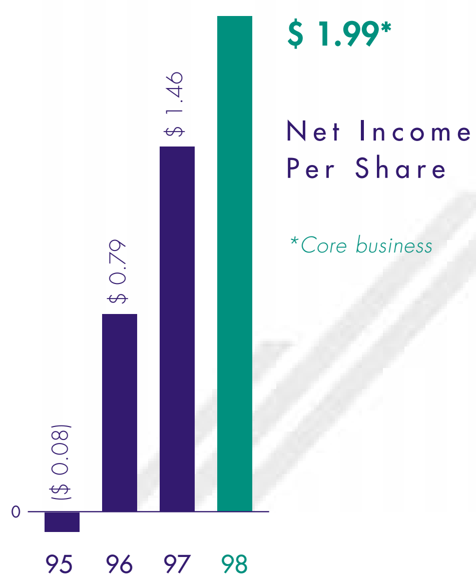
gift-wrapped toys for the children of the Dana-Farber Cancer Institute and the Connecticut Children's Medical Center. Through the generosity of customers and associates, and by teaming up with the Salvation Army, the Share Because You Care® holiday gift-giving program distributed thousands of gifts to children whose holidays would not otherwise have been so bright.

Ames is also proud to participate in the Warm Up America! project in conjunction with the Craft Yarn Council of America. To date, over 2,500 afghans have been crocheted by customers and associates and donated through local community agencies to the elderly, battered women, hospice patients, AIDS patients, and the homeless.

Performing in every way we can in our communities is not just good business practice — it's the Ames way of being a good neighbor. ■

From left to right:

Kimberly Bagdonas, Assistant Softlines Manager; Joseph R. Ettore, President and CEO; and Megan Simmons, Softlines Associate



A+ gro

Ames' success in focusing on our target market and meeting customer expectations provides us the resources to decisively invest in an even stronger future for our company.

Our underlying financial strength coupled with market conditions and the broad skills and experience of our management team made this an excellent time to be pursuing a strategy of growth through acquisitions. Our purchase of the 155-store Hills chain in 1998 and the planned conversion of nearly all of those properties into Ames stores in 1999 exemplify the opportunities we see available through this strategy.

The Hills acquisition extended Ames' reach into new communities and increased our store total by over 50 percent, bringing our total store count to over 450. The acquisition greatly strengthens our market position in the Northeast and Mid-Atlantic states, and enables us to expand into new markets in the Midwest and South. It also increased our customer base by millions of potential new customers whose income levels, lifestyles and shopping patterns closely mirror those of our existing customers. Most important, it brought us the chance to acquire a large number of stores in new markets at an attractive price, allowing us to convert them into thriving, profitable Ames stores.

In each new location, the Hills signs are coming down and are being replaced by Ames' teal color while the stores are being completely remodeled, restocked and remerchandised according to Ames' highly successful new-store format. The first round of 50 Grand Openings was successfully celebrated on April 22, 1999 with major store events, and by September all of the acquired stores will have reopened under the Ames banner, well before the 1999 Holiday Season. Guest appearances, merchandise giveaways, sweepstakes events and product demonstrations all create broad community interest in the celebrations. The millions of consumers we will reach in these previously underserved communities can then begin to enjoy the outstanding convenience, value, service and other amenities of the Ames shopping experience.

By significantly increasing our sales volume, Ames and its shareholders, associates and suppliers will reap many benefits as well. For example, both the Company and our customers

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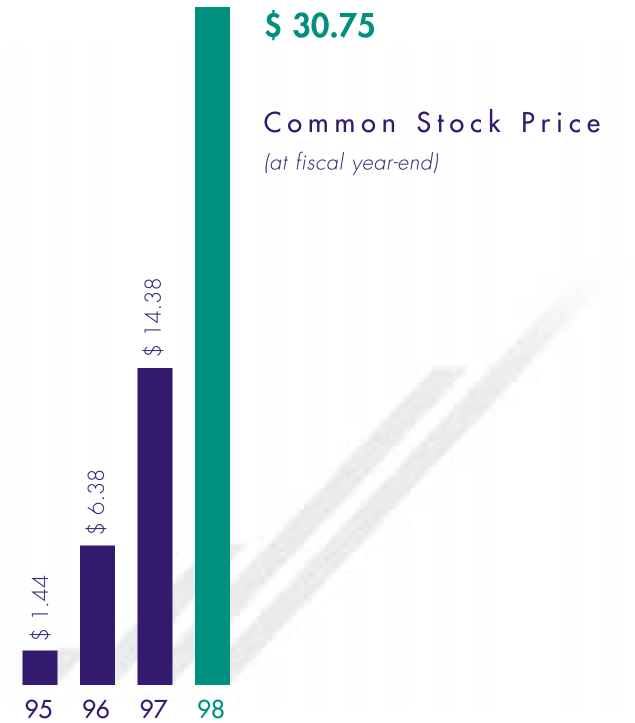
will gain from our significantly increased buying power as the nation's largest regional discount retailer. The contiguity of our new and existing markets will enhance the efficiency of our distribution systems. We can spread our very controlled general and administrative expenses over a much wider, but still very manageable, geographic operational base. Working for Ames, former Hills store associates will find greater job satisfaction and more opportunities to improve their professional skills as well as recognition and rewards through programs such as A+ Customer Service.

Despite our considerable geographic growth, there are many areas in which our target consumers have yet to enjoy the value and service that elsewhere are hallmarks of the Ames shopping experience. Our overall strategy for growth includes an ongoing search for additional expansion opportunities. ■



Ames shoppers experience A+ customer service.

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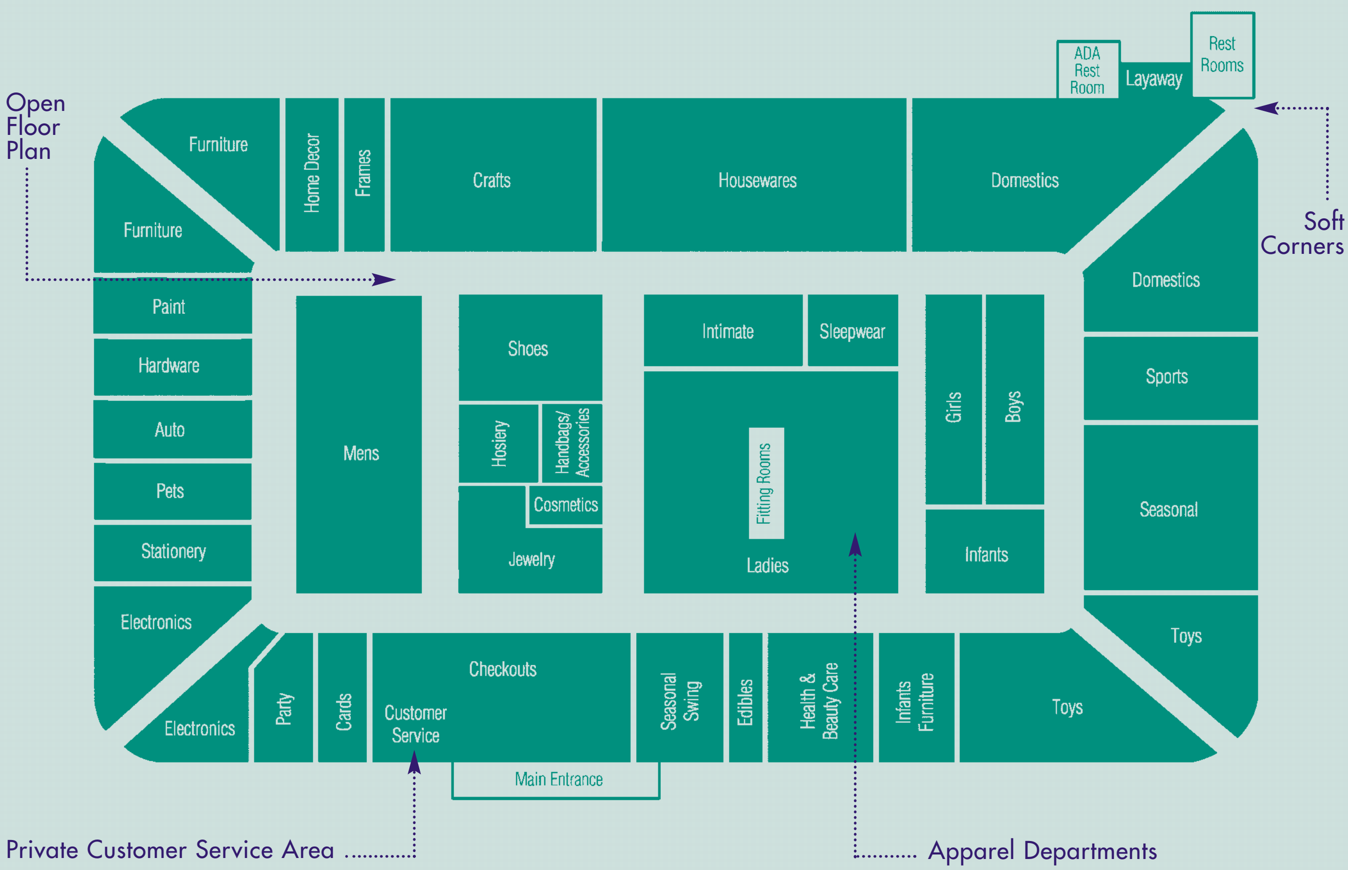
Fiscal 1998 has been an outstanding year for Ames. We are committed to solidifying our position and providing investors with consistent growth. As an integral part of our strategy, Ames will continue to review growth opportunities — selectively pursuing our markets on a regional basis. ■

Convenient Store Layout

The Ames prototype for continued growth in 1999 and beyond. Bright, attractive, easy-to-shop stores. Friendly, knowledgeable associates. Fast, efficient checkouts.



a t e g y

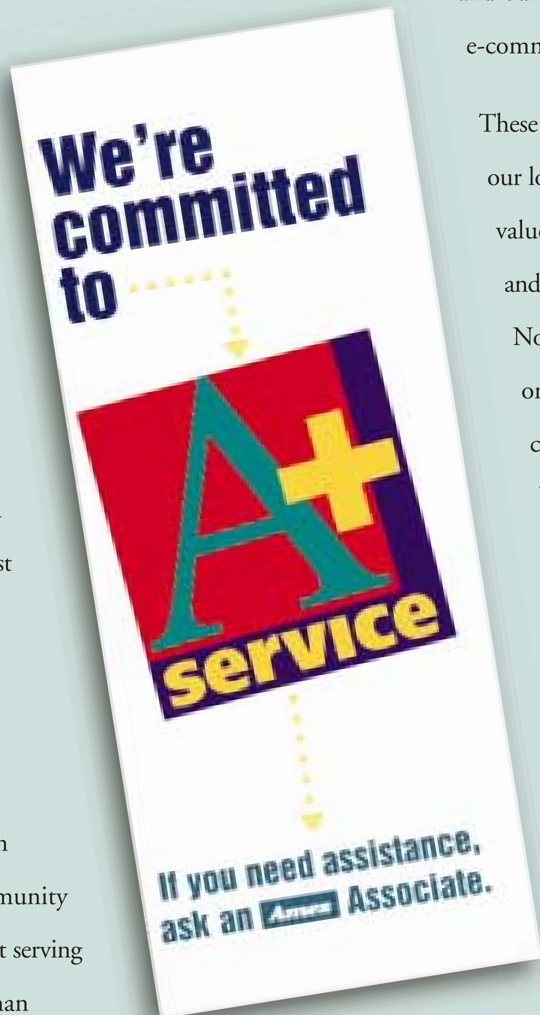
"… we offer A+ customer service. Not just a catchphrase, but the foundation of our business."

— Joseph R. Ettore

A+ f u t

The key to future growth is to build on the Ames identity in existing markets and leverage our proven store format in new markets. In recent years, Ames has successfully extended that format to many new stores. Now that same format is guiding the transformation of 150 former Hills and nine former Caldor stores into Ames stores. As these and other new stores prosper, the Ames identity will be further strengthened and will provide an even more robust foundation for continued growth.

Ames' demonstrated talent for promotional marketing will be a significant advantage as we turn the openings of new Ames stores in 1999 and beyond into major community celebrations. Our years of success at serving our targeted customer base better than any other retailer gives Ames a rock-solid platform for capitalizing on the Ames identity in new markets.



Also in 1999, we plan to keep making technological strides by further improving distribution, point-of-sale and other systems which will help us enhance our promotional flexibility. We will continue to use the Ames website to provide valuable information on the Company to our shareholders and our customers. Also, we are exploring e-commerce opportunities.

These and all of our activities are guided by our long-term strategy to build shareholder value. We enjoyed a record year in 1998, and we see many future opportunities. No one can predict the stock market or the economy, of course, but we can say with confidence that we will be totally focused on continuing to fuel the performance that has distinguished our company in recent years.

As proud as we are of our accomplishments in 1998, we will continue to strive for even higher levels of service excellence and growth in the future. We will continue working to achieve outstanding results, and we look forward to serving our customers and shareholders in 1999 and beyond. ■

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From left to right:

Rolando de Aguiar
Executive Vice President, Chief Financial and Administrative Officer

Joseph R. Ettore
President and Chief Executive Officer

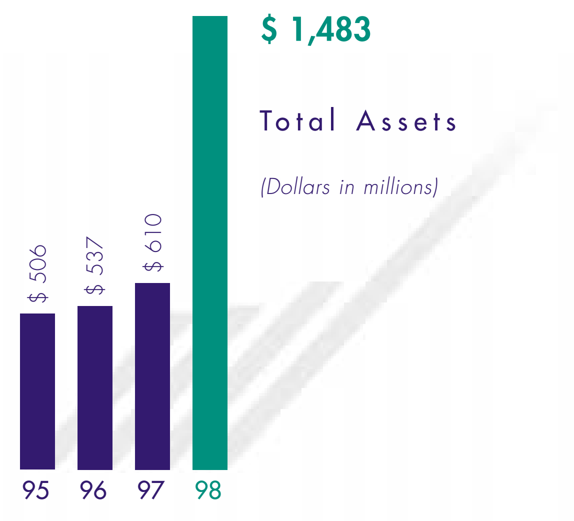
Denis T. Lemire
Executive Vice President and Chief Operating Officer

f i n a n c i a l

Ames has grown in many ways over the past few years. Ames' company culture is now one based on teamwork. Our business philosophy is very simple and is based on the three "C's": communication, cooperation, and common sense. These concepts, the foundation of the new Ames, have nurtured our profitability and growth.

Part of that growth is in the absolute sense of increasing our store base by over 50 percent. When we purchased Hills Stores Company in 1998 we acquired 155 store locations. The recently acquired Caldor sites add nine more. These acquisitions provide significant growth vehicles for the Company and will fuel performance for many years to come.

The first one-third of the former Hills stores have completed their liquidation sales, have been renovated, refixtured and remerchandised, and celebrated their successful Grand Openings as new Ames stores on April 22, 1999. The balance of the stores will go through the same process and reopen in July and September, in plenty of time for the 1999 Holiday Season.



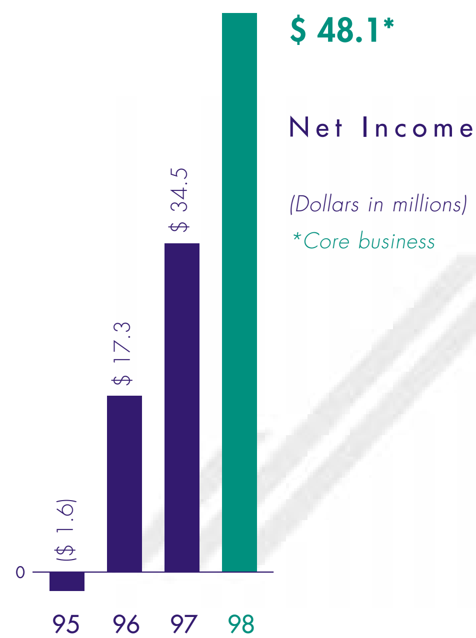
We initially financed the Hills and Caldor acquisitions with borrowings under a $650 million revolving credit facility, which is provided to us by a syndicate of banks. On April 27, 1999, we refinanced these borrowings with the proceeds from the private placement with institutional investors of a new issue of $200 million in seven-year senior notes that require no principal payments until maturity in April 2006.

f u t u r e

We have also begun marketing efforts for an underwritten public offering of approximately four million additional shares of our Common Stock. We hope to complete this offering by late May or early June and will use the proceeds to further reduce our bank borrowings and for general corporate purposes.

Our revolving credit facility remains available to us through June 2002. Together with the proceeds from our pending stock offering, this facility provides Ames with a very strong financial foundation for the future.

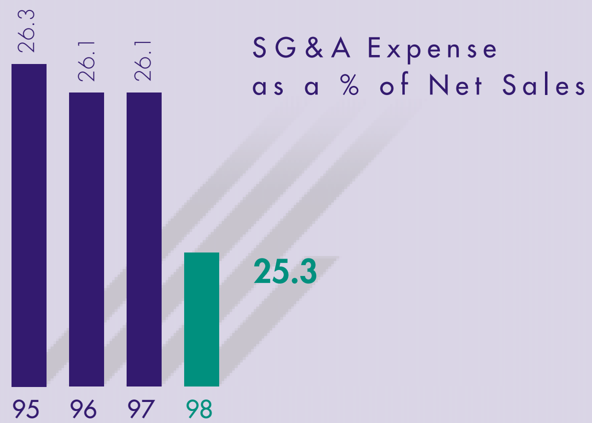
This year is off to a great start. Our associates and our vendor-partners are all working to help us attain our goals. We have secured a sound financial base on which to construct our future — another building block to add to our already established base and upon which to build value for our shareholders. ■

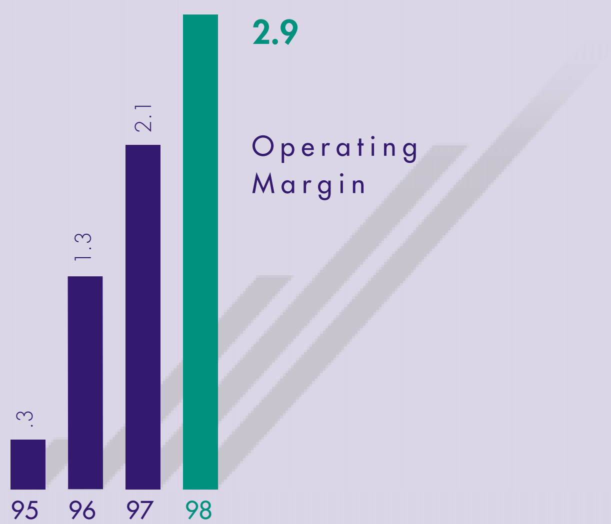


financial performance

1998 was a very good year for Ames Department Stores, Inc. It was one in which we accomplished much, and it also marked the beginning of a new era of growth for the Company. The following Management Discussion and Analysis and the accompanying financial statements provide details of the financial results recorded during the year. We also want to highlight some of the important financial events in the Company which have changed the corporate profile of Ames for the future:

- The purchase of Hills Stores Company brought total stores to over 450.
- Total market capitalization grew from $324 million at the beginning of the fiscal year to $736 million at the end — an increase of 127 percent.
- The price of the Company's common stock grew by over 110 percent.
- Net income for Ames' core business increased by 39 percent.
- Comparable store sales, which showed a 2.1 percent increase for 1997 over 1996, showed a 7.2 percent increase for 1998 over 1997 — more than triple.
- Total assets grew from $601 million at year-end 1997 to $1.483 billion for year-end 1998. An increase of 147 percent.
- Selling, general and administrative expenses, as a percentage of net sales, decreased from 26.1 percent to 25.3 percent.
- Operating margin rose to 2.9 percent.
- The Company arranged a $650 million revolving line of credit which extends until June 2002.
- The financial structure of the Company was strengthened by the sale in April 1999 of a new issue of $200 million in seven-year senior notes. ■





financial statements

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report of management to the shareholders

The management of Ames is responsible for the integrity and objectivity of the financial and operating information contained in this annual report, including the consolidated financial statements covered by the Report of Independent Public Accountants. These statements were prepared in conformity with generally accepted accounting principles and include amounts that are based on the best estimates and judgments of management.

The Company has a system of internal accounting controls that provides management with reasonable assurance that transactions are recorded and executed in accordance with its authorizations, that assets are properly safeguarded and accounted for, and that financial records are maintained so as to permit preparation of financial statements in accordance with generally accepted accounting principles. This system includes written policies and procedures, an organizational structure that segregates duties, and a comprehensive program of periodic audits by the internal auditors. The Company also has instituted policies and guidelines that require employees to maintain the highest level of ethical standards.

In addition, the Audit Committee of the Board of Directors, consisting solely of outside directors, meets periodically with management, the internal auditors and the independent public accountants to review internal accounting controls, audit results and accounting principles and practices, and annually recommends to the Board of Directors the selection of independent public accountants.

Ames

Joseph R. Ettore
President and Chief Executive Officer

Rolando de Aguiar
Executive Vice President, Chief Financial and Administrative Officer

Mark von Mayrhauser
Vice President, Controller

financial condition and results of operations

Ames Overview

Ames changed its fiscal year from the last Saturday in January to the Saturday nearest January 31, effective with the fiscal year ended January 30, 1999, which we refer to as "fiscal 1998." We made this change so that our fiscal year would coincide with the fiscal year of most other publicly-held retailers. Fiscal 1998 consisted of 52 weeks. Our fiscal year ended January 31, 1998, which we refer to as "fiscal 1997," consisted of 53 weeks. Our fiscal year ended January 25, 1997, which we refer to as "fiscal 1996," consisted of 52 weeks.

You should read the discussion that follows in conjunction with the consolidated financial statements and accompanying notes included elsewhere in this Annual Report.

Results of Operations

Fiscal 1998 Compared to Fiscal 1997

On December 31, 1998, we acquired approximately 81.3% of the outstanding voting stock of Hills Stores Company. Accordingly, the operations of Hills and its subsidiaries during the month of January 1999 are included in our consolidated results of operations for fiscal 1998. Immediately following our acquisition of Hills, we began implementing a series of initiatives to prepare for the conversion of 150 of the Hills stores into Ames stores and the permanent closure of the five remaining Hills stores. These initiatives included the termination of most of Hills' corporate and administrative operations and personnel, the announced closure of seven Ames stores that we considered to be directly competitive with acquired Hills stores and the engagement of two experienced liquidation firms, Gordon Brothers Retail Partners and The Nassi Group, to operate the Hills stores until their closure and to liquidate Hills' merchandise inventories.

Under our agreement with Gordon Brothers and The Nassi Group, we are entitled to retain from the proceeds of the liquidation sales, as a minimum guaranteed amount, 40% of the initial ticketed retail price of the inventory being sold, irrespective of the actual price at which it is sold. The remaining sale proceeds, net of the expenses of operating the stores, are payable to the liquidators as compensation for their services, subject to additional allocations to Ames to the extent the proceeds exceed specified targets. For financial reporting purposes, Hills' net sales during the month of January represent the actual sale proceeds from merchandise liquidation sales, its cost of merchandise sold represents the guaranteed minimum amount that Ames is entitled to retain, and its selling, general and administrative expenses include the portion of those proceeds that are to be paid over to the liquidators.

Because of the unique nature of our contractual arrangements with Gordon Brothers and The Nassi Group, as well as the fact that 50 Hills stores were in the process of liquidation, Hills' results for the month of January 1999 are not representative of those of a retailer operating in the ordinary course of business and are not directly comparable to Ames' results exclusive of Hills. The acquisition of Hills also resulted in various costs and charges during the month of January 1999 that impacted Ames' consolidated results. These other costs and charges consisted principally of costs associated with terminating contracts that became obsolete with the acquisition of Hills, the write-off of deferred financing costs related to a prior credit facility, interest expense for borrowings incurred to finance the acquisition and a one-time charge for the announced closing of the seven Ames stores. The following table illustrates the separate contribution of Ames' full year of operations and Hills' one month of operations to various components of the consolidated results of operations for fiscal 1998, as well as the impact on these consolidated results of the other costs and charges described above:

		Fiscal 1998			
	Fiscal 1997	Ames	Hills	Other Costs and Charges	Consolidated
			(In millions)		
Net sales	$2,233.1	$2,395.1	$112.1	$ —	$2,507.2
Costs and expenses (income):					
Cost of merchandise sold	1,603.6	1,719.9	66.3	—	1,786.2
Selling, general and administrative expenses	581.7	606.9	51.9	1.8	660.6
Leased department and other income	(25.1)	(29.2)	(0.9)	—	(30.1)
Depreciation and amortization expense, net	6.7	11.3	3.2	—	14.5
Interest and debt expense, net	11.6	11.4	1.9	1.9	15.2
Store closing charge	1.0	—	—	8.2	8.2
Income (loss) before income taxes	53.6	74.8	(10.3)	(11.9)	52.6
Income tax (provision) benefit	(19.1)	(26.7)	3.7	4.2	(18.8)
Net income (loss)	$ 34.5	$ 48.1	$ (6.6)	$ (7.7)	$ 33.8

financial condition and results of operations

The unique circumstances under which Hills' operations have been conducted since December 31, 1998 and the accounting treatment accorded those operations as a consequence of our agreement with Gordon Brothers and The Nassi Group distort any direct comparison of the principal components of Ames' consolidated results for fiscal 1998 and fiscal 1997. Accordingly, in the discussion that follows, Ames' net sales, gross margin, selling, general and administrative expense, and its leased department and other income for fiscal 1998 are presented and compared exclusive of the Hills results. The impact of the Hills acquisition is included in the comparison of depreciation and amortization expense and interest and debt expense.

Ames' net sales (which exclude sales from leased shoe departments) increased 7.3%, to $2.40 billion in fiscal 1998 from $2.23 billion in fiscal 1997, due primarily to 7.2% growth in same-store sales. Ames experienced particularly strong improvements in sales of domestics, toys, ready-to-assemble furniture and women's sportswear. In comparing results for the two fiscal years, you should bear in mind that net sales in fiscal 1997 were favorably affected by the inclusion of a full or nearly full year of operations of two stores that were closed in the beginning of fiscal 1998 and by the fact that fiscal 1997 included one additional week of operations.

Ames' gross margin increased $45.7 million in fiscal 1998 compared to fiscal 1997, but remained unchanged as a percentage of net sales at 28.2%. The gross margin rate in fiscal 1998 benefitted from a higher average markup on sales, which was partially offset by higher markdowns.

Ames' selling, general and administrative expenses increased $25.3 million in fiscal 1998, but decreased as a percentage of net sales from 26.1% in fiscal 1997 to 25.3% in fiscal 1998. The percentage decrease was primarily attributable to a reduction in store related expenses and advertising expense, partially offset by an increase in health and medical costs.

Ames' leased department and other income increased $4.1 million, or 16.3%, in fiscal 1998 compared to fiscal 1997. The increase was due primarily to the leased shoe department, layaway and vending income, as well as the receipt of funds previously held in a trust.

Ames' depreciation and amortization expense increased by $4.6 million, or 69.1%, in fiscal 1998 compared to fiscal 1997. The increase related primarily to new point-of-sale systems and store automation equipment acquired under certain capital leases. The Hills acquisition added a further $3.2 million of depreciation and amortization expense associated with the additional depreciation and amortization of its fixed assets and beneficial lease rights and the amortization of goodwill relating to the excess of the Hills acquisition cost over the value of the acquired assets. We are amortizing the beneficial lease rights using the straight-line method over the terms of the related leases (which average approximately 25 years) and are amortizing the Hills goodwill over 25 years on a straight-line basis. The amortization of the excess of our revalued net assets over equity under fresh-start reporting remained the same in fiscal 1998 as in fiscal 1997. We are amortizing this amount over a ten-year period that will conclude in January 2003.

The Hills acquisition resulted in a 31.5%, or $3.7 million, increase in consolidated interest expense, net of interest income, in fiscal 1998. Debt and capital lease obligations of Hills accounted for $1.9 million of the increase. Another $1.4 million of the increase was attributable to the non-cash write-off of deferred financing costs under Ames' prior credit facility. The balance was attributable to borrowings under our bank credit agreement to finance the costs of the acquisition.

In the fourth quarter of fiscal 1998, we recorded charges of $8.2 million in connection with the announced closing of seven Ames stores that are scheduled to close in fiscal 1999. Principal components of these charges are for lease costs and the write-down of fixed assets. We have also planned for the closing of five of the acquired Hills stores and, pursuant to the purchase method of accounting, have provided for these closings in the valuation of the acquired Hills assets. In the fourth quarter of fiscal 1997, we recorded charges of $1.6 million in connection with the closing of two stores, of which $1.0 million was classified as a store closing charge and $0.6 million was recorded as part of the cost of merchandise sold.

We recorded an income tax provision of $18.8 million in fiscal 1998, of which approximately $0.5 million will be paid in cash. In fiscal 1997, we recorded an income tax provision of $19.1 million, of which approximately $0.3 million was paid in cash. See Note 10 of the Notes to Consolidated Financial Statements for an explanation of fresh-start reporting and SFAS No. 109.

Fiscal 1997 Compared to Fiscal 1996

We reported improvements in sales and net earnings for fiscal 1997 over fiscal 1996. The improvements were due to the favorable impact of our opening 21 new stores in the preceding two fiscal years, our closing of 12 underperforming stores at the beginning of fiscal 1997 and the continued improvement in our gross margin rate. The following table sets forth various components of Ames' results of operations for fiscal 1996 and 1997 expressed in dollars and as a percentage of net sales:

financial condition and results of operations

	Fiscal 1996		Fiscal 1997	
	In millions	% of net sales	In millions	% of net sales
Net sales	$2,161.7	100.0%	$2,233.1	100.0%
Costs and expenses (income):				
Cost of merchandise sold	1,565.7	72.4	1,603.6	71.8
Selling, general and administrative expenses	564.4	26.1	581.7	26.1
Leased department and other income	(25.8)	(1.2)	(25.1)	(1.1)
Depreciation and amortization expense, net	4.7	0.2	6.7	0.3
Interest and debt expense, net	19.0	0.9	11.6	0.5
Store closing charge	6.9	0.3	1.0	—
Income before income taxes and extraordinary item	26.8	1.3	53.6	2.4
Income tax (provision)	(8.1)	(0.4)	(19.1)	(0.9)
Income before extraordinary item	18.7	0.9	34.5	1.5
Extraordinary loss, net	1.4	0.1	—	—
Net income	$ 17.3	0.8%	$ 34.5	1.5%

Net sales increased 3.3%, from $2.16 billion in fiscal 1996 to $2.23 billion in fiscal 1997, due to an increase of 2.1% in same-store sales, the inclusion of 53 weeks of operations in fiscal 1997 and the opening of new stores.

Gross margin increased $33.5 million, or 0.6% as a percentage of net sales, in fiscal 1997. The gross margin rate was favorably impacted by a slightly higher average markup on sales and a reduction in markdowns. These factors were partially offset by higher volume of "55 Gold® Savings" senior citizen markdowns in fiscal 1997. Cost of merchandise sold in fiscal 1997 included a $0.6 million charge for inventory write-downs associated with two stores that were designated for closing in fiscal 1998. Cost of merchandise sold in fiscal 1996 included a $2.8 million charge for inventory write-downs associated with 13 stores that were designated for closing in fiscal 1997.

Selling, general and administrative expenses increased $17.3 million in fiscal 1997, but remained unchanged as a percentage of net sales compared to fiscal 1996. The increase was primarily attributable to higher payroll expenses, a substantial portion of which was related to the inclusion of an additional week of operations and to federal minimum wage increases. Insurance expense increased due to a greater loss experience in fiscal 1997 compared to fiscal 1996.

Leased department and other income declined $0.7 million (or 2.7%) in fiscal 1997 compared to fiscal 1996, due primarily to a decline in sales at leased shoe departments.

Depreciation and amortization expense increased by $2.0 million, or 0.1% as a percentage of net sales, in fiscal 1997. Depreciation and amortization expense included impairment losses of $1.2 million in fiscal 1997 and $2.2 million in fiscal 1996 that were recorded pursuant to the adoption of SFAS No. 121 in the fourth quarter of fiscal 1995. Depreciation and amortization also included depreciation on capital additions subsequent to December 26, 1992, the date on which we wrote off all of our non-current assets in connection with the adoption of fresh-start reporting. The amortization of the excess of revalued net assets over equity under fresh-start reporting remained the same in fiscal 1997 as in fiscal 1996. We are amortizing this amount over a ten-year period.

Interest and debt expense, net of interest income, declined $7.4 million, or 0.4% as a percentage of net sales, in fiscal 1997. The reduction was primarily due to a reduction in the amortization of deferred financing costs, a reduction in short-term interest expense and the favorable impact of lower outstanding long-term debt and capital lease balances. The decrease in short-term interest expense reflected a decrease in short-term borrowings (weighted average of $66.5 million in fiscal 1997 compared to $86.1 million in fiscal 1996) and a decrease in interest rates under our revolving credit facility. Our average outstanding long-term debt and capital lease balances decreased to $41.3 million in fiscal 1997 from $56.3 million in fiscal 1996.

During fiscal 1997, we realized proceeds of $1.9 million from the sale of our rights under a lease, which resulted in a deferred gain of $1.7 million to be recognized over a 20-year period. During fiscal 1996,

we sold our rights under several leases for a total of $0.7 million in proceeds and recognized gains totaling $0.4 million.

In the fourth quarter of fiscal 1997, we recorded charges of $1.6 million in connection with the closing of two stores, of which $1.0 million was classified as a store closing charge and $0.6 million was classified as part of the cost of merchandise sold. Both of the stores closed in February 1998. In the fourth quarter of fiscal 1996, we recorded charges of $9.7 million in connection with the closing of 13 stores. The $9.7 million is classified in two line items: $6.9 million as a store closing charge and $2.8 million as part of cost of merchandise sold.

We recorded an income tax provision of $19.1 million in fiscal 1997, of which approximately $0.3 million was paid in cash. In fiscal 1996, we recorded a non-cash income tax provision of $8.1 million.

As a result of our termination of a revolving credit facility in December 1996, we recorded in fiscal 1996 a non-cash extraordinary charge of $1.4 million, net of tax benefit of $0.6 million. The tax benefit was recorded as a reduction of additional paid-in capital. The charge was for the write-off of the deferred financing costs related to the facility.

Liquidity and Capital Resources

Our principal sources of liquidity are our bank credit facility, cash from operations and cash on hand. Our current bank credit facility consists of a revolving credit facility of up to $650.0 million, with a sublimit of $150.0 million for letters of credit, which expires June 30, 2002. Borrowings under the bank credit facility are secured by substantially all of our assets and we are required to meet certain financial covenants after February 2000. In addition, we are required to maintain a minimum availability of at least $100.0 million. Our peak borrowing level in fiscal 1998 under this bank credit facility and a predecessor facility was $148.3 million. We believe we will have sufficient liquidity to meet our financial obligations for the foreseeable future.

Our cash position decreased by $22.1 million during fiscal 1998. The decrease was due primarily to $103.9 million paid out in the acquisition of Hills (net of cash acquired), $51.6 million of capital expenditures and $16.3 million in debt and capital lease payments, partially offset by $111.6 million in cash from operations and $44.9 million of borrowings under our bank credit facility. Our cash position increased by $11.7 million during fiscal 1997. This increase was primarily due to $56.8 million of cash from operations, partially offset by $32.9 million of capital expenditures and $15.7 million of debt and capital lease payments.

Merchandise inventories increased by $197.7 million in fiscal 1998 due to planned increases and the inclusion of $169.1 million of merchandise inventories of Hills. The Hills inventories have been valued at approximately 40% of the initial ticketed retail price of the merchandise, which represents the minimum amount we are entitled to retain out of the proceeds from the liquidation of the merchandise. Our merchandise inventories increased by $32.8 million in fiscal 1997 as a result of planned increases as well as early receipts of additional merchandise for our 40th anniversary promotion held in March 1998. We use the first-in, first-out (FIFO) method of accounting for inventories.

Net fixed assets increased by $288.3 million during fiscal 1998 due to the inclusion of $230.9 million in net fixed assets of Hills and $77.5 million of capital expenditures, including $25.9 million in new point-of-sale information equipment and related software acquired under capital leases. The Hills net fixed assets were adjusted to their estimated fair value as of the acquisition date. In fiscal 1997, our net fixed assets increased by $19.7 million.

Beneficial lease rights represent the excess of the fair market value of the acquired Hills leases over contract value of those leases. We are amortizing this amount over the terms of the related leases (which average approximately 25 years) using the straight-line method. Goodwill is being amortized over 25 years using the straight-line method.

Accounts payable increased $173.6 million during fiscal 1998 due to improved payment terms and the inclusion of Hills accounts payable of $127.8 million as of January 30, 1999. Accounts payable increased $34.2 million during fiscal 1997 due to improved payment terms and an increase in merchandise receipts in January 1998 over January 1997.

Long-term debt as of January 30, 1999 consisted of borrowings under our bank credit facility of $44.9 million and $50.9 million of Hills senior notes that remained outstanding after the acquisition.

Capital lease and financing obligations increased by $165.5 million during fiscal 1998 due to the inclusion of $147.9 million of capital lease and financing obligations of Hills and $25.9 million of new capital leases.

We have not paid any cash dividends during the past three fiscal years. The payment of cash dividends is restricted under the terms of our bank credit facility.

Capital Expenditures

Capital expenditures for fiscal 1998 were $77.5 million, including $25.9 million in new point-of-sale information equipment and related software acquired pursuant to capital leases. The capital expenditure amount also included, among other items, the opening of six new stores, the remodeling of 22 stores and the upgrading of certain management information systems. Capital expenditures for fiscal 1997 were $32.9 million and included, among other items, the opening of nine new stores, the remodeling of nine stores and the upgrading of certain management information systems, including the installation of new point-of-sale systems in ten stores.

financial condition and results of operations

Capital expenditures are expected to be approximately $210.0 million for fiscal 1999, primarily for the remodeling and conversion of 150 of the acquired Hills stores and nine former Caldor stores. We expect to finance conversion expenditures, including but not limited to, distribution center equipment purchases, store fixtures and equipment and remodeling expenses, through internally generated funds and borrowings under our bank credit facility. We expect to finance a substantial portion of new point-of-sale systems through capital leases. Land, buildings and improvements are financed principally through long-term leases.

Seasonality

Our business is seasonal in nature, with a large portion of our net sales occurring in the second half of our fiscal year as a result of the back-to-school and Christmas shopping seasons. Net sales are highest in the last fiscal quarter (31.7% in fiscal 1998). The demand for working capital is heaviest in May, and from August through November, when sufficient merchandise must be purchased for the spring, back-to-school and Christmas seasons, respectively.

Year 2000 Readiness

In operating our business, we are dependent on information technology and process control systems that employ computers as well as embedded microprocessors. We also depend on the proper functioning of the business systems of third parties, particularly the more than 3,200 vendors from whom we purchase the merchandise sold in our stores. Many computer systems and microprocessors can only process dates in which the year is represented by two digits. As a result, some of these systems and processors may interpret "00" incorrectly as the year 1900 instead of the year 2000, in which event they could malfunction or become inoperable after December 31, 1999. Systems and processors that can properly recognize the year 2000 are referred to as "year 2000 compliant."

As previously reported, we initiated a comprehensive program to prepare our computer systems and applications for the year 2000. We have spent approximately $3.8 million on this program through the end of fiscal 1998 and expect that full implementation of the program will involve an additional $2.0 million to $2.5 million, including expenditures for software and consulting services. Additionally, we estimate the allocated costs of our internal system development staff who are implementing our year 2000 initiatives to be $3.5 million to $4.0 million over the life of the project.

report of

independent public accountants

To the Stockholders and Board of Directors of Ames Department Stores, Inc.:

We have audited the accompanying consolidated balance sheets of Ames Department Stores, Inc. (a Delaware corporation) and subsidiaries as of January 30, 1999 and January 31, 1998, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the fifty-two weeks ended January 30, 1999, and the fifty-three weeks ended January 31, 1998 and the fifty-two weeks ended January 25, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Ames Department Stores, Inc. and subsidiaries as of January 30, 1999 and January 31, 1998, and the results of their operations and their cash flows for the fifty-two weeks ended January 30, 1999, and the fifty-three weeks ended January 31, 1998 and the fifty-two weeks ended January 25, 1997 in conformity with generally accepted accounting principles.

Arthur Andersen LLP

New York, New York
March 15, 1999

consolidated

statements of operations

(In thousands, except per share amounts)

	52 Weeks Ended January 30, 1999	53 Weeks Ended January 31, 1998	52 Weeks Ended January 25, 1997
Ames net sales	$2,395,092	$2,233,118	$2,161,680
Hills net sales	112,126	—	—
Total net sales	2,507,218	2,233,118	2,161,680
Costs, expenses and (income):			
Ames cost of merchandise sold	1,719,907	1,603,636	1,565,653
Hills cost of merchandise sold	66,324	—	—
Ames selling, general and administrative expenses	608,653	581,659	564,432
Hills operating expenses and agency fees	51,940	—	—
Leased department and other income	(30,164)	(25,069)	(25,811)
Depreciation and amortization expense, net	14,478	6,659	4,701
Interest and debt expense, net	15,253	11,600	19,043
Store closing charge	8,222	1,000	6,858
Income before income taxes and extraordinary item	52,605	53,633	26,804
Income tax provision	(18,775)	(19,087)	(8,149)
Income before extraordinary item	33,830	34,546	18,655
Extraordinary item — loss on early extinguishment of debt (net of tax benefit of $571)	—	—	(1,354)
Net income	$ 33,830	$ 34,546	$ 17,301
Basic net income per common share:			
Income before extraordinary item	$ 1.47	$ 1.59	0.91
Extraordinary item	—	—	(0.06)
Net income	$ 1.47	$ 1.59	$ 0.85
Weighted average common shares	23,010	21,723	20,467
Diluted net income per common share:			
Income before extraordinary item	$ 1.40	$ 1.46	$ 0.85
Extraordinary item	—	—	(0.06)
Net income	$ 1.40	$ 1.46	$ 0.79
Weighted average common and common equivalent shares	24,216	23,649	21,812

(The accompanying notes are an integral part of these consolidated financial statements.)

consolidated

balance sheet

(In thousands)

Assets	January 30, 1999	January 31, 1998
Current Assets:		
Cash and short-term investments	$ 35,744	$ 57,828
Receivables:		
Trade	13,315	8,977
Other	16,929	9,945
Total receivables	30,244	18,922
Merchandise inventories	621,509	423,836
Prepaid expenses and other current assets	16,075	12,060
Total current assets	703,572	512,646
Fixed Assets:		
Land and buildings	22,319	3,694
Property under capital leases	159,654	7,115
Fixtures and equipment	179,766	83,335
Leasehold improvements	76,095	34,646
	437,834	128,790
Less — Accumulated depreciation and amortization	(66,205)	(45,457)
Net fixed assets	371,629	83,333
Other assets and deferred charges	16,447	6,657
Deferred taxes, net	102,406	7,406
Beneficial lease rights, net	58,885	—
Goodwill, net	230,454	—
	$1,483,393	$610,042

balance sheet

(In thousands)

Liabilities and Stockholders' Equity	January 30, 1999	January 31, 1998
Current Liabilities:		
Accounts payable:		
Trade	$ 313,280	$180,971
Other	83,485	42,185
Total accounts payable	396,765	223,156
Current portion of long-term debt	—	2,000
Current portion of capital lease and financing obligations	17,799	2,177
Self-insurance reserves	29,115	16,059
Accrued compensation	48,408	31,789
Accrued expenses	163,419	41,648
Store closing reserves	59,768	12,050
Total current liabilities	715,274	328,879
Long-term debt	95,810	9,340
Capital lease and financing obligations	191,904	26,393
Other long-term liabilities	132,376	41,874
Excess of revalued net assets over equity under fresh-start reporting	24,021	30,174
Commitments and contingencies		
Stockholders' Equity:		
Preferred stock (3,000,000 shares authorized; no shares issued or outstanding at January 30, 1999 and January 31, 1998, respectively; par value per share $.01)	—	—
Common stock (40,000,000 shares authorized; 23,921,545 and 22,506,108 shares outstanding at January 30, 1999 and January 31, 1998, respectively; par value per share $.01)	239	225
Additional paid-in capital	236,667	118,971
Retained earnings	88,016	54,186
Treasury stock (79,495 shares, at cost)	(914)	—
Total stockholders' equity	324,008	173,382
	$1,483,393	$610,042

(The accompanying notes are an integral part of these consolidated financial statements.)

consolidated

statements of changes in stockholders' equity

(In thousands)

	Common Stock		Additional Paid-In	Retained	Treasury Stock		Total
	Shares	Amount	Capital	Earnings	Shares	Amount	Equity (a)
Balance, January 27, 1996	20,472	$205	$ 80,759	$ 2,339	—	$ —	$ 83,303
Exercise of stock options	2	—	4				4
Utilization of tax attributes			7,578				7,578
Net income				17,301			17,301
Balance, January 25, 1997	20,474	$205	$ 88,341	$19,640	—	$ —	$108,186
Exercise of stock options, net	772	7	3,074				3,081
Exercise of warrants	1,260	13	1,386				1,399
Utilization of tax attributes			26,170				26,170
Net income				34,546			34,546
Balance, January 31, 1998	22,506	$225	$118,971	$54,186	—	$ —	$173,382
Exercise of warrants	824	8	1,387				1,395
Exercise of stock options, net	331	3	1,106				1,109
Issuance of common stock pursuant to executive employment agreement	70	1	1,640				1,641
Issuance of restricted common stock, net	190	2					2
Vesting of restricted common stock			788				788
Utilization of tax attributes			112,775				112,775
Acquisition of treasury shares					(79)	(914)	(914)
Net income				33,830			33,830
Balance, January 30, 1999	23,921	$239	$236,667	$88,016	(79)	$(914)	$324,008

(a) No preferred stock was issued or outstanding for all periods presented.

(The accompanying notes are an integral part of these consolidated financial statements.)

consolidated

statements of cash flows

(In thousands)

	52 Weeks Ended January 30, 1999	53 Weeks Ended January 31, 1998	52 Weeks Ended January 25, 1997
Cash flows from operating activities:			
Net income	$ 33,830	$ 34,546	$ 17,301
Expenses not requiring the outlay of cash:			
Extraordinary loss on early extinguishment of debt	—	—	1,354
Income tax provision	18,275	18,764	8,149
Depreciation and amortization of fixed and other assets	15,487	6,884	5,201
Amortization of debt discounts and deferred financing costs	2,787	861	3,037
Gain on disposition of properties	—	—	(395)
Other, net	(3,514)	1,834	1,141
Cash provided by operations before changes in working capital and store closing activities	66,865	62,889	35,788
Changes in working capital:			
(Increase) decrease in receivables	(6,787)	149	(4,593)
(Increase) decrease in merchandise inventories	12,259	(32,760)	7,857
(Increase) decrease in prepaid expenses and other current assets	(2,962)	109	624
Increase in accounts payable	12,233	34,239	32,599
Increase in accrued expenses and other current liabilities	24,302	5,033	6,516
Changes due to store closing activities:			
Payments of store closing costs	(2,547)	(13,907)	(7,621)
Store closing charge	8,222	1,000	6,858
Net cash provided by operating activities	111,585	56,752	78,028
Cash flows from investing activities:			
Acquisition costs, net of cash acquired	(103,857)	—	—
Proceeds from the disposition of properties	—	1,900	690
Purchases of fixed assets	(51,602)	(32,875)	(19,805)
Purchases of leases	—	(2,801)	(3,211)
Net cash used for investing activities	(155,459)	(33,776)	(22,326)
Cash flows from financing activities:			
Borrowings (payments) under the revolving credit facilities, net	44,935	—	(4,284)
Proceeds from option exercises	4,933	4,480	4
Payments on debt and capital lease obligations	(16,262)	(15,747)	(17,388)
Purchase of treasury stock	(914)	—	—
Deferred financing costs	(10,902)	—	(2,100)
Net cash provided by (used for) financing activities	21,790	(11,267)	(23,768)
Increase (decrease) in cash and short-term investments	(22,084)	11,709	31,934
Cash and short-term investments, beginning of period	57,828	46,119	14,185
Cash and short-term investments, end of period	$ 35,744	$ 57,828	$ 46,119

(The accompanying notes are an integral part of these consolidated financial statements.)

notes to consolidated

financial statements

1. Summary of Significant Accounting Policies:

(a) Nature of operations:

Ames Department Stores, Inc. (a Delaware corporation) and its subsidiaries (collectively, "Ames" or the "Company") are retail merchandisers. As of March 1, 1999, Ames operated 453 discount department stores in 19 states in the Northeast, Midwest and Mid-Atlantic regions, as well as the District of Columbia. The stores are located in rural communities, small cities and the suburbs of larger metropolitan areas.

In 1999, the Company will remodel and convert substantially all of the acquired Hills stores to Ames stores. The remodeling and conversion process is being conducted in three stages, each stage involving approximately one-third of the Hills stores. The first stage is scheduled to be completed in late April 1999; the second and third stages are scheduled to be completed in July 1999 and September 1999, respectively.

(b) Basis of presentation:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain prior year items have been reclassified to conform to the current year presentation.

(c) Change in fiscal year:

The Company changed its fiscal year from the last Saturday in January to the Saturday nearest January 31, effective with the fiscal year ended January 30, 1999. This change was made so that the Company's fiscal year would coincide with the fiscal year of most other publicly-held retailers. There was no impact on the current year period as a result of this change. The fiscal year ended January 30, 1999 ("Fiscal 1998" or "1998") included 52 weeks. The fiscal year ended January 31, 1998 ("Fiscal 1997" or "1997") included 53 weeks. The fiscal year ended January 25, 1997 ("Fiscal 1996" or "1996") included 52 weeks.

(d) Principles of consolidation:

The consolidated financial statements include the accounts of Ames and its subsidiaries, all of which are wholly-owned. All intercompany accounts and transactions have been eliminated.

(e) Cash and short-term investments:

Ames considers all highly liquid investments with an original maturity of three months or less when purchased to be cash and short-term investments.

(f) Inventory valuation:

Inventories are valued at the lower of cost, using the first-in, first-out (FIFO) method, or market and include the capitalization of transportation and distribution center costs.

(g) Fixed assets:

Land and buildings, fixtures and equipment, and leasehold improvements are recorded at cost. Major replacements and betterments are capitalized. Maintenance and repairs are charged to earnings as incurred. The cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, with the resulting gain or loss included in earnings.

(h) Intangible assets:

Beneficial lease rights represent the excess of fair market value over contract value of certain of the leases acquired in the Hills Acquisition (as defined in Note 2 below). Goodwill represents the excess of cost over the fair value of net tangible assets acquired at the date of the Hills Acquisition. See Note 2 for further explanation.

(i) Depreciation and amortization:

Land and buildings and fixtures and equipment are recorded at cost and are depreciated on a straight-line basis over their estimated useful lives. Property under capital leases and leasehold improvements are depreciated over the shorter of their estimated useful lives or their related lease terms.

Beneficial lease rights are being amortized over the terms of the related leases (which average approximately 25 years). Goodwill is being amortized over a 25-year period.

The excess of revalued net assets over equity under fresh-start reporting is being amortized over a 10-year period. The amount recorded as a credit to depreciation and amortization was $6.2 million in each of Fiscal 1998, Fiscal 1997 and Fiscal 1996.

The unfavorable lease liability is being amortized on a straight-line basis over the applicable lease terms.

Depreciation and amortization includes adjustments recorded pursuant to the application of Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The Company did not record an impairment loss during Fiscal 1998. During Fiscal 1997 and Fiscal 1996, the Company recorded impairment losses of $1.2 million and $2.2 million, respectively.

(j) Deferred charges:

Pursuant to SOP 98-5, "Reporting on the Costs of Start-Up Activities," expenses related to new store openings are expensed when incurred. See Note 18 — Recently Issued Accounting Standards.

Debt transaction costs and related issue expenses are deferred and amortized over the term of the associated debt. Lease acquisition and related costs are deferred and amortized over the term of the lease.

(k) Income taxes:

Ames files a consolidated federal income tax return. In December 1992, Ames adopted Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109") under fresh-start reporting. Under this method, any deferred income taxes recorded are provided for at currently effective statutory rates on the differences in the basis of assets and liabilities for tax and financial reporting purposes. If recorded, deferred income taxes are classified in the balance sheet as current or non-current based upon the expected future period in which such deferred income taxes are anticipated to reverse.

(l) Self-insurance reserves:

The Company is self-insured for workers' compensation, general liability, property and casualty, and accident and health insurance claims, subject to certain limitations. The Company has insurance coverage for losses that may occur above certain levels. The Company determines its liability for claims based on the circumstances of each individual claim and estimates its liability for claims incurred but not yet reported based on historical experience. As of January 30, 1999 and January 31, 1998, Ames had established self-insurance reserves of $66.3 million and $31.7 million, respectively. The long-term portion of these reserves is classified as part of other long-term liabilities in the Consolidated Balance Sheets. These reserves are subject to changes in estimates as claims are settled or continue to remain outstanding.

(m) Leased department and other income:

Ames has an agreement with an independent contractor that allows the independent contractor to operate shoe departments within the Ames stores. Ames receives a percentage of the sales under the agreement.

(n) Earnings per common share:

In February 1997 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS No. 128"). Under SFAS No. 128, the presentation of Primary and Fully Diluted Earnings per Share was replaced by Basic and Diluted Earnings per Share. The Company adopted the provisions of SFAS No. 128 effective January 31, 1998, and has restated all periods presented.

Net income per common share for each of Fiscal 1998, 1997 and 1996 was determined by using the weighted average number of common and common equivalent shares outstanding during that fiscal year. Common equivalent shares represented the assumed exercise of the Company's outstanding Series B and Series C Warrants and stock options.

(o) Stock-based compensation:

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," ("SFAS No. 123") encourages, but does not require companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB Opinion No. 25") and related interpretations. Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of grant over the exercise price of the options.

2. Acquisition and Agency Agreement:

Acquisition of Hills Stores Company

On December 31, 1998, HSC Acquisition Corp. ("HSC"), a wholly owned subsidiary of the Company, acquired 81.3% of the outstanding common stock and 74.4% of the outstanding convertible preferred stock of Hills Stores Company ("Hills") pursuant to a tender offer made in implementation of an Agreement and Plan of Merger (the "Merger Agreement"), dated as of November 12, 1998, by and among the Company, HSC and Hills. At the closing of that acquisition (the "Hills Acquisition"), a total of $114.5 million was disbursed as follows:

- $12.7 million to Hills common shareholders for 81.3% of the shares outstanding
- $1.0 million to holders of Hills Series A convertible preferred stock for 74.4% of the shares outstanding
- $100.8 million to holders of Hills 12 1 /2% senior notes for 73.9% of the notes outstanding

The amount paid to the holders of the Hills senior notes represented a discount of approximately 30% from the face value of the acquired notes.

Holders of the Hills shares and senior notes who tendered their securities for purchase also received a deferred contingent right to receive a further cash payment out of, and based upon, Hills ultimate net recovery, if any, in a lawsuit brought by Hills in September 1995 against certain of its former directors. The outcome of this lawsuit, whether favorable or unfavorable, would result in a corresponding adjustment to goodwill recorded in connection with the Hills Acquisition.

Subsequent to the acquisition date, Hills was merged with HSC. Upon the effectiveness of that merger, the Company paid $3.3 million to retire the remaining common and preferred shares of Hills. The Company also incurred professional fees, accounting, legal and other costs of approximately $12.2 million in connection with the acquisition. These costs have been accounted for as part of the purchase price. The Hills Acquisition was funded by cash provided by operations and borrowings under the Company's 1998 Credit Agreement. (See Note 6.)

The acquisition has been recorded under the purchase method of accounting and, accordingly, the results of operations of Hills for the period from December 31, 1998 through January 30, 1999 are included in the accompanying consolidated financial statements. The aggregate purchase price of $130 million has been allocated to assets acquired and liabilities assumed based on a preliminary determination of respective fair market values at the date of acquisition and is subject to adjustment. The fair value of tangible assets acquired and liabilities assumed was $477 million and $637 million, respectively. The balance of the purchase price, $290 million, was recorded as two components: an excess of cost over net assets acquired (goodwill) of $231 million, which is being amortized over 25 years on a straight-line basis, and beneficial lease rights of $59 million, which is being amortized over the life of the respective leases (which average approximately 25 years).

In connection with the acquisition, management determined that certain previously capitalized technology costs, intangible assets, property and equipment and other assets of Hills had no future use to the Company. As a result, these assets have been effectively written-off in connection with the acquisition, and have been reflected at "zero value" (or adjusted estimated fair value where appropriate) in the above summary of fair value of assets assumed. In addition, due to the agency agreement discussed below, certain fair value adjustments were recorded to inventory and related accounts.

At the time of the acquisition, Hills operated 155 discount department stores. In 1999, the Company will remodel and convert 150 of the Hills stores to Ames stores. The five remaining Hills stores will be closed because they are in locations that are either competitive with other Ames stores or are underperforming. The remodeling and conversion process will be conducted in three stages, each stage involving approximately one third of the Hills stores. The first stage is scheduled to be completed in late April 1999; the second and third stages are scheduled to be completed in July 1999, and September 1999, respectively.

Agency Agreement Overview

Concurrent with the Hills Acquisition, the Company entered into a transition and agency agreement (the "Agency Agreement") with Gordon Brothers Retail Partners, LLC and The Nassi Group, LLC (collectively the "Agent"), which provides that the Agent serve for a period of time to operate all of the acquired Hills stores and to conduct inventory liquidation sales at each of those stores prior to its scheduled remodeling or final closure. Accordingly, the Agent is managing the sale of the inventory acquired in the Hills Acquisition as well as certain other inventory identified in the Agency Agreement (collectively the "Merchandise").

The Agency Agreement is based upon the Company providing Hills merchandise having a minimum initial retail value or selling price of $625.0 million for the Agent to manage, including both store merchandise and distribution center merchandise, on-hand at the time of the acquisition, as well as committed on-order merchandise. The Agency Agreement entitles the Company to receive out of the sale proceeds a minimum amount (the "Guaranteed Amount") equal to 40% of the initial retail value or initial ticketed selling price of the merchandise (the "Guaranteed Return"). An additional payment may be made to the Company if proceeds of sale exceed a target percentage of the initial retail value. The Agency Agreement further entitles the Company to reimbursement of certain store operating expenses (e.g., payroll, rent, advertising, etc.) out of the sale proceeds during the agency period.

The Agent will be paid a fee (the "Agency Fee") for its services pursuant to the Agency Agreement. The Agency Fee will be an amount equal to the proceeds from the sales of Hills merchandise less a deduction for the reimbursement of store operating expenses and the Guaranteed Return.

As a result of the above terms and provisions, the Company valued the acquired Hills inventory at an amount equal to the Guaranteed Return, which resulted in an opening balance sheet adjustment to reduce inventory by approximately $131.0 million. In addition, the Company has recorded a purchase commitment valuation liability of approximately $37.5 million with respect to the prior purchase commitments of Hills for merchandise ordered prior to the Hills Acquisition which the Company is legally required to honor. The recording of this valuation liability will result in an inventory valuation for these committed purchases that approximates 40% of initial retail value.

Agency Agreement Accounting

As discussed earlier, the results of operations of Hills since the date of the Hills Acquisition have been included in the accompanying consolidated financial statements. For the month of January 1999, and for the duration of the Agency Agreement, the following accounting treatment has been, and will be, applied to recognize the results of the Hills stores prior to their conversion to Ames stores during Fiscal 1999. Hills net sales will be recorded as "Hills Net Sales" and represent net sales achieved by the Hills stores prior to their conversion to Ames stores. "Hills Cost of Merchandise Sold" represents the cost of merchandise sold in connection with the Hills net sales as adjusted for the Guaranteed Return amount mentioned above. "Hills Operating Expenses and Agency Fees " include the following: the associated store expenses incurred while operating the Hills stores prior to their conversion to Ames stores, which are reimbursable to the Company out of the proceeds of Hills merchandise sales per the Agency Agreement; the Agency Fee due to the Agent for the period presented; and other expenses (e.g., non-store payroll, non-store rent, etc.) associated with supporting the Hills stores prior to their conversion to Ames stores, which are not reimbursable under the Agency Agreement.

The Agency Fee amount was determined based upon the Hills sales results for the period, less the Guaranteed Return and reimbursable Hills store expenses, as specified in the Agency Agreement. Because the Company is entitled to a Guaranteed Return and reimbursement of Hills store expenses during the term of the Agency Agreement, it is anticipated that the Company will realize "Agency Income" during the latter stages of the Agency Agreement after the sale proceeds from the liquidation of Hills merchandise decrease as a percentage of the initial retail value. As a result, any Agency Fee calculated on an interim basis may not be indicative of the total fee to be remitted to the Agent. The Agency Fee will only be determined after a final accounting for all revenues and expenses earned/incurred during the entire agency period. The final accounting will be completed during the third quarter of Fiscal 1999.

3. Supplemental Information:

The following table illustrates the separate contribution to the Company's consolidated results of operations for Fiscal 1998 of (i) the operations of Ames stores during that year, (ii) the operation of the Hills stores during January 1999 and various other costs and charges discussed below:

	Fiscal 1998			
	Ames	Hills	Other Costs and Charges	Total
	(In thousands, except per share data)			
Net sales	$2,395,092	$112,126	$ —	$2,507,218
Costs, expenses and (income):				
Cost of merchandise sold	1,719,907	66,324	—	1,786,231
Selling, general and administrative expenses	606,912	51,940	1,741	660,593
Leased department and other income	(29,160)	(1,004)	—	30,164)
Depreciation and amortization expense, net	11,261	3,217	—	14,478
Interest and debt expense, net	11,423	1,935	1,895	15,253
Store closing charge	—	—	8,222	8,222
Income (loss) before income taxes	74,749	(10,286)	(11,858)	52,605
Income tax (provision) benefit	(26,680)	3,672	4,233	(18,775)
Net income (loss)	$ 48,069	$ (6,614)	$ (7,625)	$ 33,830
Diluted net income (loss) per common share	$ 1.99	$ (0.27)	$ (0.32)	$ 1.40
Weighted average common and common equivalent shares	24,216	24,216	24,216	24,216

In January 1999, the Hills stores were being operated pursuant to the terms and conditions of the Agency Agreement (see Note 2). Approximately one-third of the Hills stores were conducting liquidation sales during January 1999 in order to prepare these stores for their conversion to Ames stores. The cost of merchandise for Hills represents the merchandise sold during January 1999 adjusted for the Guaranteed Return (see Note 2). The selling, general and administrative expenses for Hills include reimbursable store operating expenses of $25.4 million; Agency Fee of $21.7 million; and other non-reimbursable expenses of $4.8 million. The depreciation and amortization expense for Hills includes the depreciation and amortization of the revalued fixed assets, the amortization of the beneficial lease rights and the goodwill recorded in the Hills Acquisition. The interest expense reflects interest on the debt, capital lease and financing obligations assumed in the Hills Acquisition.

The "Other Costs and Charges" column in the foregoing table consists of: the cost to exit certain Ames contractual obligations rendered obsolete by the Hills Acquisition; the write-off of the deferred financing costs related to the Company's 1996 Credit Agreement; the incremental interest expense incurred in January in connection with financing the purchase price of Hills and the charge recorded in connection with the announced closing of seven Ames stores that are scheduled to close in 1999. The closings are part of planned closings resulting from the overlap in certain Ames and Hills locations.

4. Cash and Short-Term Investments:

As of January 30, 1999 there were no short-term investments. As of January 31, 1998 short-term investments totaled $37.9 million. These investments consisted of time deposits, certificates of deposit, bankers acceptances, repurchase agreements and high grade commercial paper.

5. Inventories:

Inventories are valued at the lower of cost, using the first-in, first-out (FIFO) method, or market and include the capitalization of transportation and distribution center costs.

6. Long-Term Debt:

The Company's outstanding long-term debt as of January 30, 1999 and January 31, 1998 is listed and described below:

	January 30, 1999	January 31, 1998
	(000s omitted)	
Secured Debt:		
Borrowings under the Credit Agreement	$44,935	$ —
9.5% Guaranteed First Mortgage Notes, due March 1997 through March 1999, discount rate of 11%	—	11,500
Unsecured Debt:		
12.5% Senior Notes, due July 2003	50,875	—
Total Face Value of Debt	$95,810	$11,500
Less: Current Portion	—	2,000
Debt Discount	—	160
Amount Due After One Year	$95,810	$ 9,340

The Credit Agreement

On December 31, 1998, in connection with the Hills Acquisition (see Note 2), certain of the Company's subsidiaries entered into an agreement (the "Credit Agreement") with a syndicate of other banks and financial institutions for whom Bank of America NT&SA is serving as agent. The Credit Agreement provides for a secured revolving credit facility of up to $650 million, with a sublimit of $150 million for letters of credit.

The Credit Agreement replaced a $320 million secured revolving credit facility (the 1996 Credit Agreement).

The Credit Agreement is in effect until June 30, 2002 and is secured by substantially all of the assets of the Company. The interest rate per annum on borrowings under the Credit Agreement is equal to the Base Rate (as defined in the Credit Agreement) plus 0.625% (subject to downward adjustments). Alternatively, the interest rate per annum may be equal to LIBOR (as defined in the Credit Agreement) plus 2.25% (subject to downward adjustments).

Fees required under the Credit Agreement include: (a) monthly commitment fees on the unused portion of the facility; (b) an initial closing fee and (c) an initial agency fee and annual collateral management fees for the account of the agent.

For Fiscal 1998, the weighted average interest rate on the Company's revolving credit facilities was 7.57% and the peak borrowing level was $148.3 million. As of January 30, 1999, borrowings under the Credit Agreement were $44.9 million (at a weighted average interest rate per annum of 7.57%) and $3.3 million and $11.0 million was outstanding in trade and standby letters of credit, respectively.

The amount of borrowing under the Credit Agreement may not exceed the sum of (a) an amount equal to 70% or 75% of certain inventory in the possession of the Company (depending on the period of year as provided for in the Credit Agreement) plus (b) an amount equal to 50% of certain inventory not in the possession of the Company, but covered by any outstanding letter of credit. The agent, in addition, reserves the right to adjust the total available to be borrowed by establishing reserves, making determinations of eligible inventory, revising standards of eligibility or decreasing from time to time the percentages set forth above.

The financial covenants under the Credit Agreement are limited to: minimum borrowing availability; for the quarter ended April 2000, minimum EBITDA (as defined below) and, thereafter, a minimum fixed charge coverage ratio (as defined in the Credit Agreement). EBITDA is defined as: income before (a) interest expense, (b) income tax expense or benefit, (c) depreciation and amortization expense, stock appreciation rights accruals, certain restructuring charges and other non-cash charges.

Guaranteed First Mortgage Notes

The Guaranteed First Mortgage Notes were prepaid at par by the Company in June 1998. This debt had been secured by the Company's distribution center in Mansfield, Massachusetts.

Senior Notes due 2003

The 12.5% Senior Notes due 2003 (the "Senior Notes") were, at the time of the Hills Acquisition (see Note 2), an unsecured obligation of Hills.

Pursuant to the Merger Agreement, the Company, in November 1998, made a tender offer to purchase at a stated discount all of Hills' outstanding Senior Notes, which at the time totaled $195.0 million. Upon expiration of the tender offer, the Company on December 31, 1998, paid cash of $100.8 million (including the related accrued interest) to acquire Senior Notes having a face value of $144.1 million. Senior Notes with a face value balance of $50.9 million remain outstanding.

The tendering holders of the Senior Notes, representing 73.9% of the then outstanding Senior Notes, consented to certain modifications to the indenture governing the Senior Notes. Included among the modifications were the deletion of the sections covering reporting requirements, debt and lien incurrence and asset sales and additional subsidiary guarantees.

As of January 30, 1999, the payments due on long-term debt for the next five years and thereafter were as follows:

Fiscal Years Ending January	Amount
	(000s omitted)
2000	$ —
2001	—
2002	—
2003	44,935
2004	50,875
Thereafter	—

7. Lease Commitments, Beneficial Leases and Unfavorable Lease Liability:

Ames is committed under long-term leases for various retail stores, warehouses and equipment expiring at various dates through 2023 with varying renewal options and escalating rent clauses. Some leases are classified as capital leases under Statement of Financial Accounting Standards No. 13. Ames generally pays for real estate taxes, insurance, and specified maintenance costs under real property leases. Most leases also provide for contingent rentals based on percentage of sales in excess of specified amounts.

Future minimum lease payments for leases as of January 30, 1999 were as follows:

	Lease Payments		
Fiscal Year Ending January	Capital Leases	Financing Obligations	Operating Leases
		(000's omitted)	
2000	$ 31,949	$ 8,006	$ 77,252
2001	30,815	8,096	71,564
2002	29,346	7,988	64,756
2003	27,111	4,678	57,746
2004	24,781	5,081	51,732
Thereafter	172,488	12,321	279,686
Total minimum lease payments	316,490	46,170	$602,736
Less: amount representing estimated executory costs	1,701	—	
Net minimum lease payments	314,789	46,170	
Less: amount representing interest	138,273	12,983	
Present value of net minimum lease payments	176,516	33,187	
Less: currently payable	13,409	4,390	
Long-term lease obligations	$163,107	$28,797	

At January 30, 1999, the financing obligations represent sale/leaseback arrangements. These lease arrangements, which have terms from 42 months to ten years, include options to purchase some or all of the assets either at the end of the initial lease term or renewal periods at an amount not greater than the then current fair market value of the properties.

Total payments have not been reduced by minimum sublease rentals to be received in the aggregate under noncancelable subleases of capital leases and operating leases of approximately $0.0 and $9.3 million, respectively, as of January 30, 1999. Amortization of capital lease assets was approximately $2.5 million, $0.4 million and $0.4 million for Fiscal 1998, Fiscal 1997 and Fiscal 1996, respectively.

Rent expense (income) was as follows:

	Fiscal 1998	Fiscal 1997	Fiscal 1996
		(000's Omitted)	
Minimum rent on operating leases	$55,566	$48,577	$43,856
Contingent rental expense	7,797	6,651	5,768
Sublease rental income	(1,609)	(1,730)	(1,988)

An unfavorable lease liability was recorded in December 1992 under fresh start reporting and represents the estimated liability related to lease commitments that exceeded market rents for similar locations. As of January 30, 1999 and January 31, 1998, the unfavorable lease liability is $13.7 million and $15.3 million, respectively, and is classified as part of other long-term liabilities in the Consolidated Balance Sheets. This liability is being amortized as a reduction to depreciation and amortization in the Consolidating Statements of Operations over the remaining lease terms. The amortization, recorded as a reduction to depreciation and amortization, was $1.4 million, $1.4 million and $1.6 million in Fiscal 1998, Fiscal 1997 and Fiscal 1996, respectively.

Beneficial lease rights were recorded in connection with the Hills Acquisition and represent the excess of fair market value over contract value of certain of the Hills leases. Beneficial lease rights are being amortized as part of depreciation and amortization in the Consolidated Statements of Operations over the terms of the related leases (which average approximately 25 years).

8. Stockholders' Equity: Preferred Stock and Common Stock

As provided under the Amended and Restated Certificate of Incorporation, the authorized capital stock of Ames consisted of 43,000,000 shares divided into two classes: (i) 3,000,000 shares of preferred stock, par value of $.01 per share (the "Preferred Stock"), and (ii) 40,000,000 shares of common stock, par value $.01 per share (the "Common Stock").

There were no shares of Preferred Stock outstanding as of January 30, 1999 and January 31, 1998. There were 23,921,545 and 22,506,108 shares of Common Stock outstanding as of January 30, 1999 and January 31, 1998, respectively.

The Board of Directors of the Company may authorize the issuance of one or more series of Preferred Stock and specify for each such series the voting powers (but no greater than one vote per share), designations, preferences, and relative, participating, optional, redemption, conversion, exchange or other special rights, qualifications, limitations or restrictions of such series, and the number of shares in each series.

Holders of shares of Common Stock are entitled to one vote per share on all matters to be voted upon by stockholders and are entitled to receive dividends when, as and if declared by the Board of Directors. Dividends cannot be declared under the terms of the Credit Agreement.

The Common Stock does not have any preemptive right or subscription or redemption privilege. The Common Stock also does not have cumulative voting rights, which means the holder or holders of more than half of the shares voting for the election of directors can elect all the directors then being elected. All of the shares of Common Stock are fully paid and nonassessable.

Treasury Stock

In August 1998, the Company's Board of Directors approved a stock repurchase program and authorized management to purchase up to 1.5 million shares of Common Stock. During Fiscal 1998, the Company acquired 79,495 shares of its Common Stock. During the course of the third and fourth quarters of Fiscal 1998, the Company suspended further purchases due to the pending acquisition of Hills.

Warrants

An aggregate of 200,000 Series B Warrants were issued on December 30, 1992. Each such warrant entitles the holder to purchase one share of Common Stock at any time from June 30, 1993 through December 30, 2000. The exercise price is $5.92 per share. During Fiscal 1998, 100,000 Series B Warrants were exercised.

An aggregate of 2,120,000 Series C Warrants were issued on December 30, 1992. Each such warrant entitled the holder to purchase one share of Common Stock at any time from June 30, 1993 through January 31, 1999. The exercise price was $1.11 per share. During Fiscal 1998, 723,867 Series C Warrants were exercised. On January 31, 1999, 8,635 Series C Warrants expired.

The exercise prices of the above warrants are subject to adjustment upon the occurrence of certain events, including, among other things, the payment of a stock dividend, a merger or consolidation and the issuance for consideration of rights, options or warrants (other than rights to purchase Common Stock issued to shareholders generally) to acquire Common Stock.

A holder of any of the warrants described above will not be entitled to any rights as a stockholder of the Company, including, without limitation, the right to vote the underlying shares of Common Stock, until the holder has exercised the warrants.

Stock Purchase Rights Agreement

On November 30, 1994, the Company adopted a Stock Purchase Rights Agreement (the "Rights Agreement"). Under the terms of the Rights Agreement, one purchase right ("Right"), with an exercise price of $14.00, is attached to each share of Common Stock outstanding as of, or issued subsequent to, November 30, 1994 but prior to the occurrence of certain events (as more fully described in the Rights Agreement). The Rights become exercisable in the event that a person or group (an "Acquiring Person") either acquires 15% or more of the Company's outstanding voting stock or announces an intention to acquire 20% or more of such stock. Once exercisable, each Right will, depending on the circumstances, entitle a holder, other than an Acquiring Person, to purchase shares of either the Company or an acquiring company having a market value equal to twice the exercise price. The Rights Agreement was adopted to assure that all of the Company's stockholders receive full value for their investment in the event of stock accumulation by an Acquiring Person. Unless previously redeemed by the Company, the Rights will expire on November 29, 2004.

9. Stock Options:

The 1998 Stock Incentive Plan (the "1998 Incentive Plan"), approved by stockholders in May 1998, provides for the grant of Awards (as defined in the 1998 Incentive Plan) and makes available for Awards an aggregate amount of 1,800,000 shares of Common Stock. The maximum number of shares of Common Stock with respect to which awards (as defined in the 1998 Incentive Plan) may be granted (or measured) to any individual may not exceed 300,000. With respect to such Awards under the 1998 Incentive Plan, the Company may grant awards in the form of options to purchase Common Stock provided that the exercise price shall not be less than 100% of the fair market value of the Common Stock on the date the stock option is granted.

Pursuant to the 1994 Management Stock Option Plan (the "1994 Option Plan") approved by stockholders in June 1994, the Company may grant options with respect to an aggregate of up to 1,700,000 shares of Common Stock, with no individual optionee to receive in excess of 200,000 shares of Common Stock upon exercise of options granted. The exercise prices of the options are equal to the fair market value of the Common Stock on the date the options are granted. The options become exercisable over one to five years and terminate after five to ten years from the grant date.

Pursuant to the 1994 Non-Employee Directors Stock Option Plan (the "Non-Employee Plan") approved by stockholders in May 1995, the Company may grant to non-employee directors options to purchase up to an aggregate of 200,000 shares of Common Stock. The exercise prices of the options are equal to the fair market value of the Common Stock on the date the options are granted. The options become exercisable in full six months after date of grant and terminate ten years after date of grant. Effective on the date of each annual meeting of stockholders of the Company commencing with the 1996 Annual Meeting, each non-employee director of the Company then in office was granted an option to purchase 2,500 shares, with the date of grant to be the date of such meeting. At the 1998 Annual Meeting, the stockholders approved an amendment to the Non-Employee Plan increasing the number of options granted on the date of each Annual Meeting from 2,500 to 7,500 effective as of the May 27, 1998 grant. As of January 30, 1999, 120,000 options had been granted under the Non-Employee Plan; all were exercisable.

The following table sets forth the stock option activity for all stock option plans for Fiscal 1998, Fiscal 1997 and Fiscal 1996 (shares in thousands):

	1998		1997		1996	
	Number of shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of year	914	$ 3.97	1,664	$3.73	1,320	$4.15
Granted	608	19.09	76	9.43	538	2.82
Exercised	(375)	3.90	(775)	4.03	(2)	1.76
Forfeited	(19)	12.42	(51)	3.59	(192)	4.07
Outstanding at end of year	1,128	12.00	914	3.97	1,664	3.73
Options exercisable at year-end	490	5.79	640	3.77	691	4.27
Weighted average fair value of options granted	$13.56		$7.09		$1.80	

The fair value of options granted per the above table was estimated on the date of grant using the Black-Scholes pricing model with the following assumptions: no dividend yield, expected option volatilities, a risk-free interest rate equal to U.S. Treasury securities with a maturity equal to the expected life of the option (weighted average interest rate of 5.2%, 6.4% and 6.4% for 1998, 1997 and 1996, respectively) and an expected life from date of grant until option expiration date (weighted average expected life of 5.4, 6.0 and 5.6 years for 1998, 1997 and 1996, respectively).

The following table summarizes information about stock options outstanding as of January 30, 1999:

	Options Outstanding			Options Exerciseable	
Range of Exercise Prices	Number Outstanding at 1/30/99	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Weighted Number Exercisable at 1/30/99	Weighted Average Exercise Price
$ 1.50 – 3.00	167	4.1	$ 2.34	137	$ 2.37
$ 3.13 – 4.38	270	2.1	3.70	223	3.67
$ 5.06 – 15.56	378	4.1	13.12	85	7.69
$18.38 – 24.75	313	4.3	22.94	45	23.19
	1,128	3.7	12.00	490	5.79

The Company accounts for its stock option plans under APB Opinion No. 25. Had compensation cost for the Company's 1998, 1997 and 1996 stock option grants been determined in accordance with SFAS No. 123, the Company's net income and net income per common share for Fiscal 1998, Fiscal 1997 and Fiscal 1996 would have approximated the proforma amounts below:

	Fiscal 1998		Fiscal 1997		Fiscal 1996	
	As Reported	Proforma	As Reported	Proforma	As Reported	Proforma
Net income	$33,830	$32,065	$34,546	$34,147	$17,301	$16,700
Net income per common share						
— basic	$ 1.47	$ 1.39	$ 1.59	$ 1.57	$ .85	$ .82
— diluted	$ 1.40	$ 1.32	$ 1.46	$ 1.44	$ .79	$ .77

SFAS No. 123 does not apply to stock options granted prior to 1995.

10. Income Taxes:

The Company adopted SFAS No. 109 in conjunction with the adoption of fresh-start reporting in December 1992. Under SFAS No. 109, deferred income taxes are recognized by applying the enacted statutory tax rates in future years to the changes in "cumulative temporary differences" (the differences between financial statement carrying values and the tax basis of assets and liabilities).

As a consequence of the adoption of fresh-start reporting and SFAS No. 109, any tax benefits realized for tax purposes after the Consummation Date for pre-consummation cumulative temporary differences, as well as for the pre-consummation net operating loss carryovers, are reported as additions to paid-in capital (see Consolidated Statements of Changes in Stockholders' Equity) rather than as reductions in the tax provisions in the Consolidated Statements of Operations. Tax benefits or liabilities realized for book purposes after the Consummation Date will be segregated from the pre-consummation deferred tax assets. The utilization of post-consummation deferred tax assets may reduce future income tax provisions. Such income tax provisions have no impact on the Company's taxes payable or cash flows.

On December 31, 1998, the Company completed its acquisition of approximately 81.3% of the outstanding common stock of Hills. Accordingly, the tax data presented for Fiscal 1998 reflects the tax effects of the acquisition, including the temporary differences created by the application of purchase accounting.

For Fiscal 1998, the Company recorded an income tax provision of $18.8 million, of which approximately $0.5 million will be paid in cash. For Fiscal 1997, the Company recorded an income tax provision of approximately $19.1 million of which $0.3 million was paid in cash.

The provision for income taxes is comprised of the following:

	Fiscal 1998	Fiscal 1997	Fiscal 1996
		(in millions)	
Currently Payable:			
Federal Alternative Minimum Tax	$ 0.5	$ 0.3	$ —
Deferred Non-cash Pre-emergence Tax Provision	18.3	18.8	8.1
Total Income Tax Provision	$18.8	$19.1	$8.1

Ames has the following deferred tax assets (liabilities) from pre-consummation periods and the Hills Acquisition, as of the following dates:

	As of January 30, 1999	As of January 31, 1998
	(in millions)	
Fixed assets	$ 47	$ 31
Self insurance reserves	13	13
Store closing reserves	16	9
Leases	36	15
Inventory reserves	57	—
Vacation pay reserve and other	52	16
Other purchase accounting liabilities	20	—
Net operating loss carryovers	162	172
Total deferred tax assets	403	256
Valuation allowances	(301)	(249)
Net deferred tax assets	$ 102	$ 7

The Company has reduced its valuation allowance on its deferred tax assets by $95.0 million, after consideration for recording additional valuation allowances to offset net deferred tax assets recorded in connection with the Hills Acquisition, during Fiscal 1998, which reflects the Company's expectation of utilization of net operating loss carryforwards and other deferred tax assets in the foreseeable future (2 years) after considering an adjustment for unusual activity and potential contingencies. The reduction of the valuation allowance resulted in a corresponding addition to paid-in-capital.

A significant portion of the Ames deferred tax assets (including those created by the Hills Acquisition) continue to require a valuation allowance because of the uncertainty of future recognition of such deductions. In subsequent periods, Ames may further reduce the valuation allowances, provided that the possibility of utilization of the deferred tax asset is more likely than not to occur, as defined by SFAS No. 109. Any such reduction in the valuation allowance in the near future will result in a corresponding addition to paid-in-capital for the Ames component of the deferred asset and to goodwill for the Hills components.

The Company has treated "pre-emergence net operating losses" (qualified losses incurred prior to the Consummation Date) under Section 382(1) (5) of the Internal Revenue Code ("IRC"). There is approximately $409.0 million of pre-emergence and approximately $35.0 million of post-emergence net operating losses currently available as carryovers without any annual limitation. These losses will expire between 2007 and 2012. Additionally, the Company has filed a $20 million refund claim under Section 172(f) of the Internal Revenue Code. The claim represents a 10-year carryback of qualified expenses and is currently under review by the Internal Revenue Service ("IRS"). The claim, if successful, will reduce net operating losses by approximately $47.0 million.

In addition, Ames has targeted jobs tax credit carryovers of approximately $7.0 million, which will expire in 2007, and alternative minimum tax credit carryovers of approximately $4.0 million, which have no expiration period. Federal net operating loss carryovers for fiscal years subsequent to January 27, 1990 are subject to future adjustments, if any, by the IRS.

As a result of the acquisition of the common stock of the Hills Stores Company, Ames has succeeded to the tax attributes of Hills, including net operating losses of $178.0 million and general business credits of $11.0 million. These tax attributes expire between 2000 and 2013. Ames also has succeeded to minimum tax credit carry forwards of $5.0 million, which do not expire. These tax attributes are significantly limited under Internal Revenue Code Sections 382 and 383, respectively, as a result of the change in control caused by the Hills Acquisition and the resulting deferred tax asset has been reduced accordingly.

Ames and Hills have substantial potential state net operating loss carryovers. It is difficult, however, to quantify the utilizable amounts of such state operating losses because of the uncertainty related to the mix of future profits in specific states.

The IRS has completed its audit of Hills for the 1991, 1992 and 1993 fiscal years. The final outcome of this examination will not have an adverse effect on the Company. Hills has filed a claim for a refund of federal taxes for the subsequent years. The refund claim, if successful, is approximately $7.0 million. If the Company receives this refund amount, there will be a corresponding adjustment to reduce goodwill recorded in connection with the Hills Acquisition.

11. Benefit and Compensation Plans: Retirement and Savings Plans

Ames Plan

Ames has a defined contribution retirement and savings plan (the "Ames Retirement and Savings Plan") that is qualified under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended, for employees who, after one year of service, have reached the age of 21 and have completed at least 1,000 hours of service in a 12-month period. For each participant's contribution (up to a maximum of 5% of such participant's total compensation), the Company contributes to the Retirement and Savings Plan an amount equal to 50% of such contribution. Ames funds all administrative costs incurred by the plan. Ames' expense associated with this plan amounted to approximately $3.3 million, $3.0 million and $2.9 million, in 1998, 1997 and 1996, respectively.

Hills Plan

Hills has a defined contribution retirement and savings plan (the "Hills Retirement and Savings Plan ") that is qualified under sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended, for full-time employees who are eligible to participate at the first of each calendar quarter and for all regular and part-time employees who, after one year of service have completed at least 1,000 hours of service in a 12-month period. For each participant's contribution (after one year of service) Hills contributes 100% of the first 2% from service years 1-3 and 100% of the first 4% for service years 4 and over. Hills funds all administrative costs incurred by the plan with certain exceptions. The expense associated with this plan was $0.3 million for January 1999.

The Company intends to merge the two retirement and savings plans after further review and consideration of how to structure the merged plan and how to transition to the merged plan.

Retirement Plan

Ames has an unfunded Retirement Plan for Officers/Directors (the "Retirement Plan"). It provides that every person who is employed by Ames when he or she retires, dies or becomes disabled and who serves as both a full-time officer and a director of Ames and has completed five years of service, not necessarily consecutive, in both of these capacities, is eligible for benefits under the Retirement Plan.

The maximum annual benefit under the Retirement Plan is $100,000, reduced by certain of each participant's annual Social Security benefits. Each participant in the Retirement Plan is entitled to benefits for a period of 10 years. The Company has a reserve established for potential payments under the Retirement Plan. No payments were made under this plan during the periods presented.

The G.C. Murphy Company Life Insurance Plan

The G.C. Murphy Company Life Insurance Plan (the "GCM Plan") granted a flat dollar amount (defined benefit) of group term life insurance at no cost to certain retired employees. This plan excludes G.C. Murphy Co. employees who retired from Ames after January 31, 1986. The amount of coverage varies by retiree, is payable only upon death, and has no loan or cash value. During 1997, the Company entered into a contract with an insurance company which effectively transferred to the insurance company all future liabilities associated with the GCM Plan in exchange for fixed annual payments over ten years.

Annual Incentive Compensation Plan

The Company has an Annual Incentive Compensation Plan (the "Annual Bonus Plan") that is subject to annual review by the Board of Directors. The Annual Bonus Plan provides annual incentive cash bonuses based on the achievement of the Company's financial goals for the year (and customer service goals for store and field management). There are approximately 1,500 members of management eligible under the plan. Bonus expense recorded under the plan was $8.3 million, $6.3 million, and $7.9 million for Fiscal 1998, 1997 and 1996, respectively.

Restricted Stock Awards

1995 Long Term Incentive Plan

Pursuant to the Company's 1995 Long Term Incentive Plan (the "1995 Incentive Plan"), approved by the stockholders in May 1995, the Company may make awards of an aggregate of up to 500,000 shares of Common Stock and cash payment in an amount up to 50% of the fair market value (as defined in the 1995 Incentive Plan) of the Common Stock awarded, determined as of and paid on the vesting date. Each award under the 1995 Incentive Plan vests in full on the third anniversary of the date of grant of such award. Awards may be made to the Chief Executive Officer, any Executive Vice President and any Senior Vice President of the Company. Other than for death or disability, awards which have not yet vested are forfeited upon the termination of the employment of the executive.

As of January 30, 1999, awards aggregating to 355,000 shares of Common Stock had been made to certain executives of the Company, 60,000 of which remain unvested.

1998 Incentive Plan

Pursuant to the Company's 1998 Incentive Plan (as defined in Note 9), awards aggregating 195,000 shares of Common Stock were made to certain executives during Fiscal 1998. Fifty percent (50%) of each stock award under the 1998 Incentive Plan vests on the fourth anniversary from the date of grant and 50% on the fifth anniversary. There is no cash payment to be made relative to the vesting of the grant.

The shares for the outstanding awards under both the 1995 Incentive Plan and the 1998 Incentive Plan have been issued and are being held in custody by the Company on behalf of the grantees thereof. A portion of the estimated market value of the awards, including the cash, has been accrued as compensation expense as of January 30, 1999. The Company recorded as compensation expense for the 1995 Incentive Plan and the 1998 Incentive Plan $1.9 million, $2.0 million, and $1.1 million during 1998, 1997 and 1996, respectively.

Stock Appreciation Rights

All stock appreciation rights ("SARs") granted to certain members of management in connection with the Company's emergence from Chapter 11 protection in 1992 expired as of December 30, 1997. During Fiscal 1997, a total of 166,683 SARs were exercised. The Company recorded an expense of $0.1 million and $0.8 million in 1997 and 1996, respectively. In June 1998, the Company extended the employment agreement with Joseph R. Ettore, Chief Executive Officer and President. In connection therewith, Mr. Ettore was granted 125,000 SARs which entitle Mr. Ettore to receive in cash upon exercise the excess of (a) the average closing price of a share of Common Stock during the twenty trading days prior to the exercise date over (b) $2.00 (representing the exercise price of certain rights surrendered by Mr. Ettore). Mr. Ettore's SARs are exercisable on or after May 31, 1999.

Income Continuation Plan

Certain officers of Ames participate in an Income Continuation Plan ("ICP"), which guarantees up to one year's salary in the event of termination other than for cause. As of January 30, 1999, the Company had no obligations under the ICP.

Key Employee Continuity Benefit Plan

Ames has a Key Employee Continuity Benefit Plan (the "Continuity Plan") that covers all officers, Vice President and above, and certain other employees of Ames. If the employment of any participant in the Continuity Plan is terminated, other than for death, disability, cause (as defined in the Continuity Plan) or by the participant other than for good reason (as defined in the Continuity Plan), within 18 months after a change of control of Ames, the participant will receive a lump sum cash severance payment. The severance payment is 2.99 times Base Compensation for the President and Executive Vice Presidents, two times Base Compensation for Senior Vice Presidents and selected Vice Presidents and one times Base Compensation for other Vice Presidents. Base Compensation is defined generally as the sum of the participant's annual base compensation in effect immediately prior to the participant's termination plus one-third of the value of the cash and stock bonuses paid to the participant during the 36 months ending on the date of termination. For purposes of the Continuity Plan, a change of control includes but is not limited to the acquisition by any person of beneficial ownership of 20% or more of Ames outstanding voting securities or the failure of the individuals who constituted the Board of Directors at the beginning of any period of 12 consecutive months to continue to constitute a majority of the Board during such period.

Hills Post Retirement Benefits

Hills has a retiree medical plan that provides medical benefits to eligible retirees of Hills. This plan is accounted for in accordance with Statement of Financial Accounting Standards No. 106: "Employers' Accounting for Postretirement Benefits Other Than Pensions" ("FAS 106"). This statement requires accrual of postretirement benefits during the years an employee provides services. Hills has historically funded benefit costs principally on a pay-as-you-go basis. The status of the plan is as follows:

	January 30, 1999
	(in thousands)
Accumulated post retirement benefit obligation ("APBO") for:	
Active employees	$2,293
Retirees	61
	2,354
Plan assets at fair value	—
Unfunded APBO	2,354
Unrecognized actuarial gain	1,442
Accrued post retirement benefit cost	$3,796

The assumed health care cost trend rate used in measuring the APBO was 9% in fiscal year 1998 (7% for Medicare eligible retirees); grading down to 5% (5% for Medicare eligible retirees) by fiscal year 2002 and remaining at that level thereafter. A one percentage point increase in the assumed health care cost trend rate would increase the APBO at the end of fiscal year 1998 by $348,300 (or by 15%) and the service and interest cost by $34,100 (or by 11%). Conversely, a one percentage point decrease in the assumed healthcare cost trend rate would decrease the APBO at the end of fiscal year 1998 by $278,600 (or by 12%) and the service and interest cost by $27,200 (or by 9%). The assumed discount rate used in determining the APBO was 7%.

12. Commitments and Contingencies:

Wages and Hour Litigation

Since March 1995, the Company has been named as a defendant in several class action complaints which allege that the Company was obligated to pay overtime to its hardlines and softlines assistant store managers. The Company has consistently stated its belief that these positions are appropriately designated as exempt positions not calling for overtime pay. The Company has settled several of these cases. These settlements have not required any change in the Company's treatment of the status of its hardlines and softlines assistant managers. The Company is vigorously defending one remaining case which it does not believe represents a material exposure.

Other Matters

The Company is party to various claims and legal proceedings covering a wide range of matters that arise in the ordinary course of its business. The Company believes that its probable liability as to these matters will not have a material adverse effect on its consolidated financial position or results of operations.

13. Supplemental Cash Flow Information:

	Fiscal 1998	Fiscal 1997	Fiscal 1996
	(000's omitted)		
Cash paid for interest and income taxes were as follows:			
Interest	$ 12,166	$11,655	$15,149
Income taxes	125	73	2
Ames entered into other non-cash investing and financing activities as follows:			
New capital lease obligations	$ 25,859	$ 2,940	$ 375
Issuance of Common Stock under the 1998 Incentive Plan	2	—	—

14. Fair Values of Financial Instruments:

The Financial Accounting Standards Board requires disclosure of the fair value of financial instruments under Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments." The following methods and assumptions were used by the Company in estimating the fair value disclosures for its financial instruments.

The Company's financial instruments as of January 30, 1999 and January 31, 1998 were cash and short-term investments, long-term debt, and the Series C Warrants, which expired on January 30, 1999. For cash and short-term investments, the carrying amounts reported in the Consolidated Balance Sheets approximated fair values. For long-term debt obligations, the fair values were estimated using a discounted cash flow analysis (based upon the Company's incremental borrowing rates for similar types of borrowing arrangements). The fair value of the Series C Warrants was based on the market trading price at year-end times the number of such warrants that were outstanding.

The carrying amounts and fair values of the Company's financial instruments at January 30, 1999 and January 31, 1998 were as follows:

	Fiscal 1998		Fiscal 1997	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(000's omitted)			
Cash and short-term investments	$35,744	$35,744	$57,828	$57,828
Long-term debt				
Secured debt	44,935	44,935	11,340	11,500
Unsecured debt	50,875	50,875	—	—
Series C Warrants	—	—	—	9,065

15. Store Closing Charges:

In the fourth quarter of 1998, the Company recorded charges of $8.2 million in connection with the closing of seven stores that overlap markets with acquired Hills stores. Four stores are expected to close in August 1999, and three stores are expected to close in October 1999.

In the fourth quarter of 1997, the Company recorded charges of $1.6 million in connection with the closing of two stores. The $1.6 million is classified in two line items: $1.0 million as store closing charge and $0.6 million as part of cost of merchandise sold.

In the fourth quarter of 1996, the Company recorded charges of $9.7 million in connection with the closing of thirteen stores. The $9.7 million is classified in two line items: $6.9 million as store closing charge and $2.8 million as part of cost of merchandise sold.

The following items represent the major components of the total charges recorded in January 1999, January 1998 and January 1997 in connection with store closings:

Item	Fiscal 1998	Fiscal 1997	Fiscal 1996
		(in thousands)	
Lease costs	$ 6,254	$ 363	$ 3,535
Net fixed asset write-down	1,161	394	1,149
Severance costs	370	113	773
Other	437	130	1,401
Store closing charge	8,222	1,000	6,858
Inventory write-down	—	560	2,860
Total charges	$ 8,222	$ 1,560	$ 9,718

The lease costs provided for in the store closing charge include all projected occupancy costs from date of closing until estimated lease disposition date.

16. Leased Department and Other Income:

The following is a summary of the major components of the "Leased department and other income:"

Item	Fiscal 1998	Fiscal 1997	Fiscal 1996
		(in thousands)	
Leased department income	$17,914	$16,592	$16,932
Concession and vending income	1,508	1,252	1,148
Layaway service fees	2,644	2,605	2,382
Various other	8,098	4,620	5,349
	$30,164	$25,069	$25,811

17. Extraordinary Items:

In December 1996, the Company terminated a prior credit agreement (Note 6) and recorded a non-cash extraordinary charge of $1.4 million, net of tax benefit of $0.6 million, for the write-off of deferred financing costs.

18. Recently Issued Accounting Pronouncements

In April 1998, AICPA issued SOP 98-5, "Reporting on the Costs of Start-Up Activities" which requires start-up costs, as defined, to be expensed as incurred. Pursuant to SOP 98-5, previously capitalized start-up costs are required to be written-off as a cumulative effect of a change in accounting principle. SOP 98-5 is effective for financial statements for fiscal years beginning after December 15, 1998.

The Company elected early adoption of SOP 98-5 during the fourth quarter of Fiscal 1998, retroactively effective to the first quarter of Fiscal 1998. The Company's previous policy was to expense all store pre-opening costs in the year of opening, amortizing them from the date of opening through the balance of the fiscal year. No cumulative effect has been recorded on the Company's Consolidated Statement of Operations. However, the quarterly financial data presented in Note 19 has been restated to properly reflect the effect of the SOP in each of the presented quarterly results.

In February 1998, the Financial Accounting Standards Board released Statement No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("SFAS No. 132"). This statement, which is effective for fiscal years beginning after December 15, 1997, modifies and expands disclosure requirements. Adoption of SFAS No. 132 will have no impact on the Company's consolidated financial condition or results of operations.

19. Quarterly Financial Data (Unaudited):

Summarized unaudited quarterly financial data (in thousands except for per share amounts) for the last three fiscal years are shown below.

	First	Second	Third	Fourth
		(in thousands, except per share data)		
Fiscal 1998:				
Net sales	$ 499,048	$ 536,297	$ 599,188	$ 872,685 (b)
Gross margin	138,434	156,836	163,094	262,619 (b)
Net income (loss) (a)	(2,943)	8,386	6,000	22,387 (b)
Net income (loss) per share — basic	(0.13)	0.37	0.27	0.96 (b)
— diluted	(0.13)	0.36	0.25	0.92 (b)
Fiscal 1997:				
Net sales	$432,601	$503,567	$527,573	$769,377
Gross margin	118,366	146,348	148,231	215,809
Income (loss) before extraordinary item	(5,930)	7,378	3,519	29,579 (c)
Income (loss) per share before extraordinary item	(0.28)	0.31	0.15	1.23
Net income (loss)	(5,930)	7,378	3,519	29,579 (c)
Net income (loss) per share — basic	(0.28)	0.34	0.16	1.32
— diluted	(0.28)	0.31	0.15	1.23
Fiscal 1996:				
Net sales	$438,667	$499,107	$516,876	$707,030
Gross margin	117,402	139,725	141,224	194,355
Income (loss) before extraordinary item	(6,998)	4,514	421	20,718 (d)
Income (loss) per share before extraordinary item	(0.34)	0.21	0.02	0.93
Net income (loss)	(6,998)	4,514	421	19,364 (d)
Net income (loss) per share — basic	(0.34)	0.22	0.02	0.95
— diluted	(0.34)	0.21	0.02	0.87

(a) First three quarters restated according to SOP 98-5 (Note 18).

(b) Includes the financial results of Hills Stores Company for January 1999.

(c) Includes charges of $1.6 million related to the closing of two (2) stores (Note 15).

(d) Includes charges of $9.7 million related to the closing of thirteen (13) stores (Note 15).

20. Pro Forma Information (Unaudited):

The following table reflects unaudited pro forma combined results of operations of the Company and Hills on the basis that the Hills Acquisition had taken place at the beginning of each of the fiscal years presented:

	Year Ended	
	January 30, 1999	January 31, 1998
	(in thousands except per share data)	
Net sales	$4,131,194	$4,001,392
Net income (loss)	(54,903)	27,635
Earnings (loss) per Common Share	$ (2.39)	$ 1.27

These unaudited pro forma results have been prepared for comparative purposes only. They do not purport to be indicative of the results of operations which actually would have resulted had the Hills Acquisition been consummated at the beginning of fiscal 1997 or fiscal 1998, or of future results of operations of the consolidated entities.

The above pro forma net income and earnings per common share amounts for the year ended January 30, 1999 reflect the previously recorded write-down of Hills deferred tax assets of approximately $49.6 million (which is net of a reversal of approximately $5.9 million of accrued tax liabilities). Excluding the write-down of the Hills deferred tax assets recorded as of October 31, 1998, pro forma net loss and loss per common share would have been $5.3 million and $0.23, respectively for the year ended January 30, 1999.

21. Subsequent Events:

On March 4, 1999, the Company entered into an agreement with Caldor Corporation to purchase seven of its stores in Connecticut, one store in Massachusetts and a 649,000 square foot distribution center in Westfield, Massachusetts, for a cash purchase price of $40.0 million. Under the terms of the agreement, the Company will assume Caldor's leases for the eight stores and the distribution center and will acquire all of the store fixtures and all racking, sorting systems and materials handling equipment in the distribution center.

On March 26, 1999, the United States Bankruptcy Court for the Southern District of New York approved the Company's right to purchase the leases for the stores and the distribution center.

On March 26, 1999, the Company entered into an agreement with Caldor Corporation for the purchase of an additional store in Massachusetts for a cash purchase price of $2.7 million. This agreement is subject to competing bids and the approval of the Bankruptcy Court.

selected

company data

Selected Financial Data

The following selected financial data of Ames should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as the Consolidated Financial Statements and related notes appearing elsewhere in this Annual Report.

	Fiscal Year Ended Jan. 30, 1999 (a)	Fiscal Year Ended Jan. 31, 1998 (g)	Fiscal Year Ended Jan. 25, 1997	Fiscal Year Ended Jan. 27, 1996	Fiscal Year Ended Jan. 28, 1995
			(in thousands except per share data)		
Net sales	$2,507,218	$2,233,118	$2,161,680	$2,104,231	$2,142,827
Net income (loss)	33,830 (h)	34,546 (b)	17,301 (c)	(1,618) (d)	17,026 (e)
Net income (loss) per common share (f)	1.40	1.46 (b)	.79 (c)	(.08) (d)	.79 (e)
Total assets	1,483,393	610,042	536,793	502,582	533,388
Long-term debt and capital leases	287,714	35,733	38,220	52,531	77,095

(a) Includes Hills financial results for the month of January 1999.

(b) Includes charges of $1.6 million for the costs associated with the closing of two stores.

(c) Includes charges of $9.7 million for the costs associated with the closing of thirteen stores and an extraordinary loss, net of tax, of $1.4 million for the early extinguishment of debt.

(d) Includes charges of $20.9 million for the costs associated with the closing of seventeen stores and property gains of $9.1 million.

(e) Includes an extraordinary loss, net of tax, of $1.5 million for the early extinguishment of debt; property gains of $7.5 million; and a non-recurring gain of $12.0 million for a litigation settlement.

(f) Net income (loss) per common share has been restated to conform to the requirements of Statement of Financial Accounting Standards No. 128 "Earnings per Share" ("SFAS No. 128"). See Note 1 to the Consolidated Financial Statements included in this Annual Report for a further description of the provisions of SFAS No. 128.

(g) Fiscal year ended January 31, 1998 consisted of 53 weeks; all other years presented consisted of 52 weeks.

(h) Includes $8.2 million for the costs associated with the closing of seven stores.

selected

company data

Market for the Company's Common Stock

The following table provides the high and low last sale prices for our common stock as reported on NASDAQ for the fiscal quarterly periods indicated below.

	Fiscal 1998		Fiscal 1997	
	Low	High	Low	High
1st Quarter	$14	$25 1/2	$ 6 1/4	$10 1/4
2nd Quarter	21 1/8	29 5/8	6 3/4	12 13/16
3rd Quarter	10 1/2	25 3/8	12 5/8	18
4th Quarter	18 1/8	32 1/2	12 3/8	19 5/8

On March 31, 1999, the last reported sale price of our common stock was $37 1/8. On that date, there were approximately 6,487 holders of record of the common stock.

We paid no quarterly dividends to the holders of our common stock during these periods. Dividends cannot be declared under the terms of our bank credit facility. Any future determination to pay cash dividends will be at the discretion of the board of directors and will be dependent upon our financial condition, operating results, capital requirements and such other factors as the board of directors deems relevant.

Forward-Looking Statements

When used in this Annual Report, in any future filings by the Company with the Securities and Exchange Commission, in the Company's press releases and in oral statements made with the approval of an authorized executive officer, the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "projected," "projections," "plans," or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company wishes to caution readers not to place undo reliance on any such forward-looking statements, which speak only as of the date made.

Disclosure About Market Risk

We have exposure to interest rate volatility primarily relating to interest rate charges applicable to revolving loans under our bank credit facility. These loans bear interest at rates which vary with changes in (i) the London Interbank Offered Rate (LIBOR) or (ii) a rate of interest announced publicly by Bank of America NT&SA.

We do not speculate on the future direction of interest rates. As of January 30, 1999, approximately $44.9 million of our debt bore interest at variable rates. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our consolidated financial position, results of operations or cash flows would not be significant.

Annual Meeting

The Annual Meeting of Shareholders of Ames Department Stores, Inc. will be held on Wednesday, June 16, 1999, at 10:00 a.m. at Ames Corporate Office in Rocky Hill, Connecticut. A formal Notice of Meeting, a Proxy Statement and Form of Proxy will be mailed to Stockholders in May.

For Fax copies of Ames' most recent news releases, please dial 800 925 7792.

Visit Ames on-line at: http://www.AmesStores.com

corporate
directory

Board of Directors

Paul M. Buxbaum
Chairman of the Board,
Ames Department Stores, Inc.
President,
Buxbaum Group & Associates, Inc.

Francis X. Basile
Retired Chairman and
Chief Executive Officer,
CIT Group/Factoring, Inc.

Alan Cohen
Chairman, Alco Capital Group, Inc.

Joseph R. Ettore
President and Chief Executive Officer,
Ames Department Stores, Inc.

Richard M. Felner
Head of
Richard M. Felner Associates

Sidney S. Pearlman
Retired Senior Vice President
General Merchandise Manager,
Younkers, Inc.

Laurie M. Shahon
President, Wilton Capital Group

Corporate Officers

Joseph R. Ettore
President and Chief Executive Officer

Denis T. Lemire
Executive Vice President and
Chief Operating Officer

Rolando de Aguiar
Executive Vice President,
Chief Financial and
Administrative Officer

James J. Aglio, Jr.
Senior Vice President,
General Merchandise
Manager, Home

Lisa M. Bachmann
Senior Vice President,
Allocation and Planning

Eugene E. Bankers
Senior Vice President, Marketing

Richard L. Carter
Senior Vice President,
Human Resources

David S. Covitz
Senior Vice President, General
Merchandise Manager, Hardlines

Paul C. Lanham
Senior Vice President,
Chief Information Officer

David H. Lissy
Senior Vice President, General
Counsel and Corporate Secretary

Alfred B. Petrillo, Jr.
Senior Vice President, Store Planning

Grant C. Sanborn
Senior Vice President,
Store Operations

Sanford H. Sansavera
Senior Vice President, General
Merchandise Manager, Softlines

John Tempesta
Senior Vice President, Logistics

James A. Varhol
Senior Vice President,
Asset Protection

John R. French
Regional Vice President, Stores

John J. Hlis
Vice President, Real Estate

Beth Ann Keegan
Vice President, Advertising

Richard J. Marsan
Vice President, Store Planning
and Merchandise Presentation

Richard B. McDonald
Vice President, Store Operations

Nick Nuccetelli, Jr.
Regional Vice President, Stores

Dorene E. Robotti
Vice President, Legal

Joseph J. Staffieri
Vice President,
Human Resources Administration

Ronald R. Templeton
Regional Vice President, Stores

Michael A. Torti, Jr.
Regional Vice President, Stores

Mark von Mayrhauser
Vice President, Controller

David C. Yen
Vice President, Corporate Development
and Treasurer

Corporate Information

NASDAQ listing

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Form 10K, or Quarterly Reports

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